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DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1988
(H.R. 4333 AND S. 2238)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

Overview

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the provisions of H.R. 4333 and S. 2238 (The Technical Corrections Act of 1988), introduced on March 31, 1988. H.R. 4333 was introduced by House Committee on Ways and Means Chairman Rostenkowski and Congressman Duncan; and S. 2238 was introduced by Senate Committee on Finance Chairman Bentsen and Senator Packwood.

The bills are divided into two titles: Title I provides technical corrections to the Tax Reform Act of 1986 ("Reform Act") (P.L. 99-514); and Title II provides technical corrections to other recently enacted tax legislation: the Superfund Revenue Act of 1986 (P.L. 99-499), the Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509), and the Omnibus Budget Reconciliation Act of 1987 (which includes the Revenue Act of 1987, the Pension Protection Act, the vaccine excise tax provisions, and Social Security Act amendments) (P.L. 100-203). Provisions in the bills for which no descriptions are provided are clerical in nature or are transition rules.

The amendments made by the Technical Corrections Act of 1988 are intended to correct, clarify, or conform various recently enacted tax provisions. Provisions in the bills are generally effective as if included in the original legislation, unless otherwise indicated.

Legislative background

Technical corrections to the Tax Reform Act of 1986 and other 1986 tax legislation was introduced on June 10, 1987, as H.R. 2636 and S. 1350.[2] As amended, these provisions were included as Subtitle B of Title X (Revenue Provisions) of the Omnibus Budget Reconciliation Act of 1987 (H.R. 3545) [3] as passed by the House of Representatives in October 1987. As further amended, the Senate Committee on Finance included technical corrections provisions in its budget reconciliation submission to the Senate Committee on the Budget in October 1987. The technical corrections provisions were not included in the Senate-passed amendment to H.R. 3545, nor were they included in the bill as enacted.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238)* (JCS-10-88), March 31, 1988.

[2] For a description of these bills as introduced, see Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)* (JCS-15-87), June 15, 1987.

[3] See H. Rpt. No. 100-391, Part 2, October 26, 1987, pp. 1141-1507.

TITLE I.—TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986

I. INDIVIDUAL INCOME TAX PROVISIONS (SEC. 101 OF THE BILL)

1. Rate of tax with respect to certain unclaimed cash (sec. 101(a)(1) of the bill, sec. 101 of the Reform Act, and sec. 6867 of the Code)

Present Law

If the IRS determines that the assessment or collection of tax would be jeopardized by delay, the IRS may use expedited procedures as specified in the Internal Revenue Code (secs. 6851 and 6861). For purposes of these expedited assessment and collection procedures, special rules apply if an individual who is in possession of cash (or cash equivalents) in excess of $10,000 does not claim the cash either as his or as belonging to another identifiable person who acknowledges ownership (sec. 6867).

These rules provide that the cash is presumed to represent gross income of a single individual and that the collection of tax will be jeopardized by delay. Under present law, such income is taxable to the possessor of the unclaimed cash at a 50-percent rate (sec. 6867(b)), i.e., the highest income tax rate imposed by Code section 1 as in effect immediately prior to the rate reductions made by the Act.

Explanation of Provision

The bill provides that the rate of tax applicable with respect to unclaimed amounts of cash described in section 6867 is the highest income tax rate specified in Code section 1. This rate is 38.5 percent for taxable years beginning in 1987 and 28 percent for subsequent years.

2. Rate of accumulated earnings tax (sec. 101(a)(2) of the bill, sec. 101 of the Reform Act, and sec. 531 of the Code)

Present Law

The Act generally reduces the maximum rate of Federal income tax on individuals to 28 percent, effective for taxable years beginning after 1987. As a conforming amendment, the personal holding company tax rate (sec. 541) also is reduced to 28 percent for taxable years beginning after 1987. However, the Act did not similarly reduce the accumulated earnings tax rate (sec. 531), notwithstanding that each of these additional corporate taxes is imposed to prevent taxpayers from using a corporation to avoid income tax on the corporation's shareholders.

Explanation of Provision

The bill provides that the rate of the accumulated earnings tax is 28 percent, effective for taxable years of the corporation beginning after December 31, 1987. This amendment shall not be treated as a change in tax rates for purposes of Code section 15.

3. Phaseout of personal exemptions for married taxpayer filing separate return (sec. 101(a)(3) of the bill, sec. 101 of the Reform Act, and sec. 1(g) of the Code)

Present Law

For taxable years beginning after December 31, 1987, the Act phases out the benefits of the 15-percent rate bracket and the deduction for personal exemptions if the taxpayer's taxable income exceeds a specified amount. In the case of a separate return filed by a married taxpayer, the maximum amount of additional tax resulting from the phaseout of the 15-percent bracket is determined as if a joint return had been filed. This rule is intended to prevent certain married taxpayers from avoiding the full effect of the phaseout of the 15-percent bracket by filing separate returns. The Act did not include a parallel provision with respect to phaseout of the deduction for personal exemptions.

Explanation of Provision

The bill provides that, in the case of a married individual filing a separate return, the maximum amount of additional income tax liability resulting from the phaseout of the deduction for personal exemptions is determined as if the taxpayer was allowed a personal exemption for the taxpayer's spouse. This rule is intended to prevent married taxpayers from avoiding the full effect of the phaseout of personal exemptions by filing separate returns.

4. Standard deduction and filing requirement for elderly or blind dependents (secs. 101(b)(1)-((2) of the bill, sec. 102 of the Reform Act, and secs. 63(c)(5) and 6012(a) of the Code)

Present Law

The Act provides a standard deduction for individuals who do not itemize. Elderly or blind taxpayers who do not itemize are allowed an additional standard deduction amount above the basic standard deduction allowed to all nonitemizers.

The additional standard deduction amount is $600 for an elderly or blind individual who is married (whether filing jointly or separately) or is a surviving spouse; the additional amount is $1,200 for such an individual who is both elderly and blind. An additional standard deduction amount of $750 is allowed for a head of household who is elderly or blind ($1,500, if both), or for a single individual (i.e., an unmarried individual other than a surviving spouse or head of household) who is elderly or blind ($1,500, if both). Thus, for example, for 1987 and 1988 a single elderly individual is entitled to a basic standard deduction of $3,000 plus an additional standard deduction of $750, for a total of $3,750.

Under the Act, the standard deduction for an individual who may be claimed as a dependent on another taxpayer's return is limited to the greater of $500 or the amount of the individual's earned income (Code sec. 63(c)(5)). The filing threshold for such an individual is the amount of standard deduction that is allowable (sec. 6012(a)(1)(C)).

Explanation of Provision

The bill modifies the standard deduction limitation imposed under section 63(c)(5) on a taxpayer who may be claimed as a dependent on the return of another taxpayer to apply only with respect to the basic standard deduction; thus, the limitation does not also apply with respect to the additional standard deduction amount allowed to elderly or blind individuals.

Accordingly, an elderly or blind individual who may be claimed as a dependent on another taxpayer's return may claim a basic standard deduction up to the greater of $500 or the amount of earned income, plus the additional standard deduction amount (e.g., $600 for a married taxpayer). Since this additional standard deduction amount is not limited by the amount of the dependent's earned income, it may be applied against any remaining income (earned or unearned) that has not been offset by the allowance of the basic standard deduction as described above.

Section 6012(a)(1)(C)(i), which relates to the filing threshold for certain individual taxpayers, is amended to conform to the modification to section 63(c)(5). Thus, for example, an unmarried elderly individual who may be claimed as a dependent on her daughter's tax return was required to file a return for 1987 only if the elderly individual either (1) had total gross income exceeding $3,750 or (2) had unearned income exceeding $1,250.

5. Third-party reimbursements (sec. 101(b)(3) of the bill, sec. 132 of the Reform Act, and secs. 62 and 527 of the Code)

Present Law

An employee is permitted an above-the-line deduction for employee business expenses only if such expenses (1) are incurred in connection with the performance by him or her of services as an employee and (2) are reimbursed under a reimbursement or other expense allowance arrangement with his or her employer (Code sec. 62(a)(2)(A)). The conference report on the Act states that the Treasury Department may prescribe regulations treating reimbursements of employees by third parties in the same manner as reimbursements by employers.[1]

Explanation of Provision

The bill amends the Code to clarify the statutory support for the Treasury regulations called for by the Act. Thus, an employee who incurs business expenses on behalf of the employer and is reimbursed for those expenses pursuant to a reimbursement arrangement is permitted an above-the-line deduction for those expenses, regardless of whether the reimbursement is provided by the employer or by a third party. To the extent these reimbursements do not exceed the expenses incurred, existing Treasury regulations provide that the employee need not report on the employee's tax return either the expenses or the reimbursements provided that the employee properly accounts for such expenses. This rule also applies regardless of whether the reimbursement is provided by the employer or by a third party.

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[1] See H. Rpt. 99-841, 99th Cong., 2d Sess. (1986), at p. II-33 fn. 4.

The bill also includes a conforming change to the provision relating to the tax treatment of political organizations (sec. 527). Thus, for example, a State-elected official could be reimbursed by an account authorized under State law (and properly qualified under the Code) to pay the official's office expenses. To the extent those expenses are otherwise deductible business expenses and the reimbursement does not exceed those expenses, the State official would be permitted an above-the-line deduction for those expenses.

6. Rule for inflation adjustments to earned income credit (sec. 101(c) of the bill, sec. 111 of the Reform Act, and sec. 32(i) of the Code)

Present Law

The Act modifies the earned income credit to provide for inflation adjustments. An inflation adjustment to the earned income credit is rounded to the nearest multiple of $10 (sec. 32(i)(3)).

Explanation of Provision

Under the bill, the provision relating to rounding of inflation adjustments to the earned income credit applies to the sum of the earned income credit amount (prior to adjustment) plus the inflation adjustment, rather than to the inflation adjustment amount itself. Thus, the statute provides that the dollar amount of the earned income credit after being increased by the inflation adjustment is rounded to the nearest multiple of $10 (or, if such dollar amount is a multiple of $5, such dollar amount is increased to the next higher multiple of $10).

7. Cross-references to scholarship exclusion provisions in private foundation rules (sec. 101(d)(1) of the bill, sec. 123 of the Reform Act, and secs. 4945(g)(1) and 4941(d)(2)(G) of the Code)

Present Law

Code section 4945(g)(1) provides that certain scholarship or fellowship grants that are made by private foundations do not constitute taxable expenditures if the grant "is subject to the provisions of section 117(a)." Section 4941(d)(2)(G) provides that certain scholarship or fellowship grants that are made by private foundations to government officials do not constitute acts of self-dealing if the grants "are subject to the provisions of section 117(a)." The Act limits the section 117(a) exclusion for certain scholarship and fellowship grants made to degree candidates to amounts not exceeding the recipient's tuition and course-related expenses, and repeals the prior-law limited exclusion for nondegree candidates.

Explanation of Provision

The bill amends the cross-references in the private foundation provisions cited above to refer to certain scholarship or fellowship grants that would be subject to the provisions of Code section 117(a) as in effect immediately prior to amendment of that section by the Act. Accordingly, the amendments made by the Act to the section 117(a) exclusion do not treat scholarship or fellowship grants made by a private foundation that would not have triggered section 4945 or 4941 excise taxes under such prior law as taxable expenditures or self-dealing acts merely because such grants exceed the amount excludable by degree candidates under section 117 as amended by the Act or merely because such grants (up to the amount excludable under prior law) are made to nondegree candidates.

8. Treatment of certain scholarship or fellowship grants to nonresident aliens (sec. 101(d)(2) of the bill, sec. 123 of the Reform Act, and secs. 1441(b) and 871(c) of the Code)

Present Law

Under present and prior law, Code section 1441(b) provides for a 14-percent withholding rate on amounts received by a nonresident alien who is temporarily present in the United States under an "F" or "J" visa that are "incident to a qualified scholarship to which section 117(a) applies, but only to the extent such amounts are includible in gross income." Under section 871(c), such amounts are subject to U.S. tax on a net income basis.

Under prior law, a nondegree candidate could exclude from gross income under section 117 a limited amount of a scholarship or fellowship granted by an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. The prior-law exclusion for a nondegree candidate in any one year could not exceed $300 times the number of months in the year for which the recipient received scholarship or fellowship grant amounts, and no further exclusion was allowed after the nondegree candidate had claimed exclusions for a total of 36 months (i.e., a maximum lifetime exclusion of $10,800). However, this dollar limitation did not apply to that portion of the scholarship or fellowship received by the nondegree candidate for travel, research, clerical help, or equipment.

The Act repeals the limited prior-law exclusion under section 117 for grants received by nondegree candidates. As a result, scholarship or fellowship grants received by nonresident aliens who are nondegree candidates are subject to withholding at a 30-percent rate, and to U.S. tax on a gross income basis, since no amount of such grants is "incident to a qualified scholarship to which section 117(a) applies."

The Act also provides that in the case of a scholarship or fellowship grant received by a degree candidate, an exclusion under section 117 is available only to the extent the individual establishes, in accordance with the conditions of the grant, that the grant was used for (1) tuition and fees required for enrollment or attendance of the student at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution.

Explanation of Provision

The bill provides that withholding at a 14-percent rate applies to amounts received as a scholarship or fellowship for study, training, or research at an educational institution (described in sec. 170(b)(1)(A)(ii)) in the United States by a nonresident alien who is not a degree candidate, if the grant is made by the educational institution or any other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. Also, such amounts eligible for the 14-percent withholding rate are subject to U.S. tax on a net income basis under section 871(c).

As under present law, withholding at 14 percent and taxation on a net income basis apply to amounts received by a nonresident alien who is a degree candidate that are incident to a qualified scholarship or fellowship to which section 117(a) applies, but only to the extent includible in gross income (e.g., amounts received for room, board, or travel).

The bill applies the above rules to "M" visa holders as well as "F" and "J" visa holders.[2]

9. Coordination of two-percent floor and certain other deduction limitation provisions (sec. 101(f)(1) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Code section 67 provides that miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and certain items allowable under sec. 212) are deductible by itemizers only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (AGI). Other limitations also apply to particular items that constitute miscellaneous itemized deductions. For example, the last sentence of section 162(a) limits certain deductions for away-from-home living expenses incurred by Members of Congress to $3,000 per year.

Explanation of Provision

The bill clarifies that the two-percent floor on miscellaneous itemized deductions applies prior to application of the $3,000 limitation on certain deductions for Members' away-from-home living expenses. Thus, for example, a Member with AGI of $100,000 who has $5,000 of away-from-home living expense deductions described in section 162(a) (disregarding the dollar limitation contained therein) would be allowed such deductions in the amount of $3,000.[3]

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[2] Similar amendments relating to "M" visa holders are made to Code secs. 3121(b)(19), 3231(e)(1), 3306(c)(19), and 7701(b)(5)(D), and sec. 210(a)(19) of the Social Security Act.

This clarification is consistent with the general rule under the Act to apply certain deduction limitation provisions in the following order: first, provisions disallowing a percentage of a deduction (e.g., sec. 274(n), generally limiting meal and entertainment deductions to 80 percent of the amount otherwise allowable); second, provisions disallowing a fixed dollar amount of certain deductions (e.g., the two-percent floor on miscellaneous itemized deductions); and third, provisions establishing a deduction ceiling (e.g., the $3,000 limit in the last sentence of sec. 162(a) and certain dollar limitations in sec. 217 on deductions for moving expenses).

10. Application of two-percent floor to trusts and estates (secs. 101(f)(2), (3), and (4) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Under the Act, miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and items deductible under sec. 212) are deductible only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (Code sec. 67). In listing the itemized deductions that are not subject to the two-percent floor, the Act specifically includes the deduction under section 170 (for charitable contributions by individuals or corporations), but does not include the deduction for estates and trusts under section 642(c) (relating to items paid or permanently set aside for a charitable purpose).

Section 67(e) provides that, for purposes of section 67, adjusted gross income (AGI) of an estate or trust is computed in the same manner as for an individual, except that certain costs paid in connection with the administration of the estate or trust are treated as allowable in arriving at AGI. The provision does not state the treatment, for purposes of section 67, of deductions under sections 651 and 661 (relating to certain amounts distributed by a trust or estate).

Section 67(c) provides that Treasury regulations generally are to (1) prohibit the indirect deduction through pass-through entities of amounts that are not allowable as a deduction if paid or incurred directly by an individual, and (2) contain such reporting requirements as are necessary to accomplish this object. Such regulatory authority does not, however, apply with respect to estates or trusts.

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[3] In addition, if a Member has expenses subject to the $3,000 limitation and other miscellaneous itemized deductions, the amounts disallowed by the two-percent floor are disallowed proportionately. For example, assume that a Member with AGI of $100,000 has $5,000 of away-from-home expenses qualifying for the deduction (disregarding application of the $3,000 limit and the two-percent floor, but after application of the 80-percent rule for meal and entertainment expenses) and $5,000 of other miscellaneous itemized deductions, for a total of $10,000 of potential deductions subject to the two-percent floor. Application of the two-percent floor would limit these deductions to $8,000, and the amount disallowed because of the two-percent floor would be disallowed proportionately. Thus, after application of the two-percent floor, the Member could deduct $4,000 of the away-from-home expenses and $4,000 of the miscellaneous itemized deductions. The former amount (i.e., the away-from-home expenses) is further limited to $3,000 because of the special limitation on deducting Members's expenses in sec. 162(a). Thus, the Member could deduct a total of $7,000 of miscellaneous itemized deductions.

Explanation of Provision

The bill provides that deductions under section 642(c), relating to items paid or permanently set aside for a charitable purpose, are not miscellaneous itemized deductions subject to the new two-percent floor.

In addition, the bill provides that the distribution deductions allowable to an estate or trust under sections 651 and 661 are treated as allowable in computing AGI of the estate or trust. Similarly, deductions for costs paid or incurred in connection with the administration of an estate or trust, and which would not have been incurred if the property were not held in such trust or estate, are treated as allowable in computing AGI of the estate or trust. Thus, deductions under sections 651 and 661, and such administrative costs of an estate or trust, are not limited under the new two-percent floor, and are treated as allowable in arriving at AGI of the trust or estate for purposes of section 67.

The bill modifies sections 67(c) and 67(e) to provide that the regulatory authority of the Treasury with regard to indirect deductions through pass-through entities shall not, except as provided in regulations, apply to estates and trusts. Under this provision, the Treasury has regulatory authority to apply the two-percent floor at the beneficiary level, rather than at the entity level, with respect to trusts required to distribute income currently.

11. Clarification of exceptions to certain rules limiting meal and entertainment deductions (secs. 101(g)(1), (2), and (3) of the bill, sec. 142 of the Reform Act, and secs. 274(k)(2), 274(m)(1), and 274(n)(2) of the Code)

Present Law

Code section 274(k) denies deductions for the expense of any food or beverages unless such expense is not lavish or extravagant under the circumstances, and unless the taxpayer or an employee of the taxpayer (including, for this purpose, certain independent contractors) is present at the furnishing of such food and beverages. Code section 274(n) generally limits the amount allowable as a deduction for the expense of any food or beverages, or any entertainment expense, to 80 percent of the amount otherwise allowable. Special limitations apply under section 274(m)(1) to deductions for luxury water transportation. However, the above limitations under the Act do not apply to items that are not treated as entertainment expenses for purposes of section 274(a) by reason of certain of the exceptions listed in section 274(e).

Explanation of Provision

The bill clarifies that the exceptions to sections 274(k)(2), 274(m)(1), and 274(n)(2) described by cross-references to certain paragraphs of section 274(e) are not subject to the limitations of sections 274(k)(2), 274(m)(1), or section 274(n)(2), whether or not such items (disregarding sec. 274(e)) would be treated as entertainment expenses for purposes of section 274(a).

The bill also provides that the Treasury has regulatory authority to provide additional exceptions to the taxpayer-presence requirement in section 274(k)(2). For example, an exception could be provided for meal expenses of the taxpayer's spouse and children incurred by them as moving expenses deductible pursuant to section 217, even though the taxpayer travelled separately to the new job location. As a further example, the taxpayer-presence requirement could be waived by Treasury regulations in the situation in which a business reimburses away-from-home meal expenses of a job applicant who travels to the business location the night before his or her job interview and has a meal alone in the hotel where he or she is staying.

12. Applicability of percentage reduction rule to meal costs deductible as moving expenses (sec. 101(g)(4) of the bill, sec. 142 of the Reform Act, and secs. 274(n), 3121(a)(11), 3306(b)(9), and 3401(a)(15) of the Code)

Present Law

The Act generally reduces by 20 percent any amount otherwise allowable as a deduction for food or beverage expenses (sec. 274(n)). For example, this reduction rule applies to meal expenses that are allowable (within certain limitations) as moving expenses deductible under section 217. In the case of an employee who is reimbursed for meal expenses by his or her employer pursuant to certain reimbursement arrangements, the percentage reduction rule applies at the employer level.

Explanation of Provision

Under the bill, if an employer pays or reimburses meal expenses of an employee that otherwise are deductible (within certain limitations) as meal expenses under section 217, the percentage reduction rule applies at the employee level, as in the case of unreimbursed meal expenses.

Also, the bill resolves a problem involving circular provisions concerning application of the percentage reduction rule with respect to certain reimbursed meal costs deductible as moving expenses, under which the meal reimbursement is excluded from wages for employment tax purposes to the extent it is deductible, but the extent of deductibility depends on whether or not the reimbursement is treated as wages. Under the bill, meal reimbursements are excludable from wages for employment tax purposes to the extent that at the time of payment of such remuneration, it is reasonable to believe that a corresponding deduction is allowable under section 217 as determined without regard to the percentage reduction rule.

13. Home office deduction rules (sec. 101(h) of the bill, sec. 143 of the Reform Act, and sec. 280A(c) of the Code)

Present Law

Section 280A limits certain deductions with respect to business use of a dwelling unit that is used by the taxpayer during the taxable year as a residence. The Act limits the amount of the home office deduction to the taxpayer's gross income from such business use, reduced by (1) the deductions allowed for expenses that are deductible without regard to business use and (2) the deductions "allocable to the trade or business in which such use occurs (but which are not allocable to such use)." The Act also provides that deductions that are disallowed by reason of exceeding the gross income limitation may be taken into account as a deduction (allocable to such business use of the dwelling unit) for the succeeding taxable year (sec. 280A(c)(5)).

Explanation of Provision

The bill adds an express reference to rental activity, as well as trade or business activity, in the gross income limitation as modified by the Act. Also, the bill clarifies that, when a deduction for business use of a dwelling unit is carried forward to a succeeding taxable year by reason of the business income limitation in section 280A(c)(5), such deduction shall continue to be allowable only up to the amount of income from the business in which it arose, whether or not the dwelling unit is used as a residence during such taxable year.

II. CAPITAL COST PROVISIONS (SEC. 102 OF THE BILL)

A. Depreciation and Regular Investment Tax Credit

1. Depreciation provisions

a. Effect of depreciation on earnings and profits of foreign corporations (sec. 102(a)(3) of the bill, sec. 201(d) of the Reform Act, and sec. 312(k)(4) of the Code)

Present Law

The Act requires the use of an alternative depreciation system in determining the earnings and profits of a corporation. Under this system, depreciation allowances are computed using the straight line method (without regard to salvage value) and a recovery period that generally equals the property's class life.

Explanation of Provision

The bill clarifies that the alternative depreciation system applies in determining the earnings and profits of all foreign corporations.

b. Mid-quarter convention (secs. 102(a)(5), 102(a)(23), and 102(c)(2) of the bill, secs. 201(a) and 203(d) of the Reform Act, and sec. 168(d)(3) of the Code)

Present Law

If the aggregate depreciable bases of property that is placed in service during the last three months of any taxable year exceed 40 percent of the aggregate depreciable bases of all property that is placed in service during the entire taxable year, then a mid-quarter convention applies to the property that is placed in service during that taxable year. For purposes of the 40-percent limitation, all the members of an affiliated group (within the meaning of sec. 1504 including the rules of sec. 1504 (b)) are treated as one taxpayer.

Under the mid-quarter convention, property that is placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) is treated as placed in service (or disposed of) on the mid-point of the quarter. The mid-quarter convention applies only to property that is subject to the accelerated cost recovery system as modified by the Act ("modified ACRS").

Explanation of Provision

The bill provides that in determining whether the the 40-percent limitation has been exceeded for any taxable year, property that is not subject to the revised depreciation system (i.e., property that would be subject to modified ACRS but for the application of the general effective date or a transitional rule) is taken into account only in applying the limit for taxable years that begin before October 1, 1987. Property that is subject to the revised depreciation system, but the cost of which is not recovered under modified ACRS because of an exception contained in section 168 (e.g., property that is placed in service in a churning transaction or property depreciated under a unit-of-production or income forecast method), is never taken into account in determining whether the mid-quarter convention applies.

The bill also provides that property that is placed in service and disposed of within the same taxable year is disregarded for purposes of making the 40 percent determination. In applying the 40 percent test, depreciable basis is to be used rather than cost or any other measure of property placed in service.

c. Certain property placed in service in churning transactions (sec. 102(a)(6) of the bill, sec. 201(a) of the Reform Act and sec. 168(f)(5) of the Code)

Present Law

The Act prescribes rules to prevent taxpayers from bringing certain property placed in service after December 31, 1980, under modified ACRS, where the result would be to qualify such property for more generous depreciation.

Explanation of Provision

The bill clarifies that the determination of whether property would qualify for more generous depreciation is made by comparing depreciation deductions for the first taxable year (whether a short year or a full year), assuming a half-year convention.

Further, the anti-churning rule is inapplicable to property to which modified ACRS applied in the hands of the transferor.

Finally, with respect to property that is subject to the anti-churning rule, the depreciation deduction is to be determined under the law in effect before the enactment of the Tax Reform Act of 1986. Thus, in the case of property that was placed in service by the transferor before January 1, 1981, the transferee would be subject to the pre-1981 depreciation rules. Similarly, for property that was subject to ACRS (before amendment by the Act) in the hands of the transferor, the transferee would be subject to the pre-1987 ACRS rules (including the pre-1987 ACRS anti-churning rules).

d. Treatment of certain transferees (sec. 102(a)(7) of the bill, sec. 201(a) of the Reform Act, and sec. 168(i)(7) of the Code)

Present Law

In certain cases, the transferee of property is treated as the transferor for purposes of computing depreciation deductions with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

Explanation of Provision

The bill clarifies that in any case where ACRS, as in effect before enactment of the Act, applied to property in the hands of the transferor, the transferee will use pre-enactment ACRS for purposes of computing depreciation deductions.

The bill clarifies that the "step in the shoes" rule applies to transactions between members of an affiliated group of corporations filing a consolidated return. In addition, the Act was not intended to apply to a mere change in form of ownership not involving a sale or exchange. For example, the change from ownership as tenants-in-common to condominium ownership not involving percentage ownership would not require the owners to begin depreciating the property over a new period.

The bill deletes the exception for transactions to which the antichurning rule applies.

e. Exception for certain property subject to U.S. tax and used by foreign persons (sec. 102(a)(8) of the bill, sec. 201(a) of the Reform Act, and sec. 168(h)(2)(B) of the Code)

Present Law

The Act provides that modified ACRS is inapplicable to motion picture films, video tapes, and sound recordings. The tax-exempt entity leasing rules contain an exception for foreign persons with respect to this property.

Explanation of Provision

The bill deletes the tax-exempt entity leasing exception for motion picture films, video tapes, and sound recordings. The bill also repeals related rules that applied for purposes of the investment tax credit.

f. Applicable depreciation method (sec. 102(a)(11) of the bill, sec. 201(a) of the Reform Act, and secs. 168(b) and (c) of the Code)

Present Law

The Act permits taxpayers to elect to apply the alternative depreciation system to any class of property for any taxable year. Generally, the alternative depreciation system requires use of the straight-line method over a recovery period equal to property's present class life. For purposes of the depreciation preference under the alternative minimum tax, the cost of property generally is recovered using the 150-percent declining balance method over the present class life.

Explanation of Provision

The bill permits taxpayers to elect for regular tax purposes the depreciation rules that apply for alternative minimum tax purposes (i.e., 150-percent declining balance method over the class life).

g. Election to expense certain depreciable business assets (secs. 102(b)(1) and (c)(8) of the bill, secs. 202 and 203 of the Reform Act, and sec. 179 of the Code)

Present Law

The Act modified the provision under which a taxpayer may elect to treat the cost of qualifying property as an expense that is not chargeable to capital account. The costs for which the election is made are allowed as a deduction for the taxable year in which the qualifying property is placed in service, subject to a $10,000 limitation each year ($5,000 for a married individual filing a separate return). The amount eligible to be expensed is limited for any taxable year in which the aggregate cost of qualifying property placed in service exceeds $200,000; for every dollar of investment in excess of $200,000, the $10,000 ceiling is reduced by $1. In addition, the amount eligible to be expensed is limited to the taxable income derived from active trades or businesses. Costs that are disallowed because of the limitation based on taxable income are carried forward to the succeeding taxable year. These modifications apply to property placed in service after December 31, 1986, in taxable years ending after that date.

Explanation of Provision

The bill clarifies that costs that are disallowed because of the limitation based on taxable income may be carried forward to an unlimited number of years. Also, the deduction of costs that are carried forward is limited by the $10,000 ceiling (subject to any reduction due to investments that exceed $200,000) in every taxable year.

The bill also clarifies the application of the expensing limitations for taxable years (other than a calendar year) that include January 1, 1987. First, the cost of any qualifying property that is placed in service before January 1, 1987, and that is expensed under the law in effect before the effective date of the amendments made by the Act reduces the amount of qualifying property that is eligible to be expensed under the Act. For example, if a fiscal year taxpayer elects to expense $4,000 of qualifying property that is placed in service before January 1, 1987, then the maximum amount of qualifying property placed in service during the same taxable year and on or after January 1, 1987, that is eligible to be expensed is $6,000.

Second, all qualifying property that is placed in service during a fiscal year that includes January 1, 1987, is to be taken into account in determining whether the $200,000 limitation has been exceeded for such fiscal year. If the $200,000 limitation has been exceeded for a fiscal year the includes January 1, 1987, only the amount of property placed in service during the same taxable year and on or after January 1, 1987, that is eligible to be expensed would be reduced by the excess. Finally, the taxable income derived from an active trade or business for purposes of the taxable income limitation equals the taxable income for the entire fiscal year reduced by the cost of property that was expensed for that year under the law in effect before the effective date of the amendments made by the Act.

h. Effective dates; transitional rules (secs. 102(c) and (d) of the bill and secs. 203 and 204 of the Reform Act)

Present Law

The Act modified ACRS for property placed in service after December 31, 1986. The Act provided an election to apply modified ACRS to certain property placed in service after July 31, 1986. Such an election disqualified property under the investment tax credit transitional rules, which are discussed below.

The Act provides certain exceptions to the general effective date. Under these exceptions, transition property generally must be placed in service by a prescribed date that is determined by reference to the ADR midpoint for the property. Property that is described in a transition rule contained in section 204(a) of the Act is treated as having an ADR midpoint of 20 years and, thus, generally must be placed in service before January 1, 1991.

Explanation of Provision

The bill clarifies that the election to apply modified ACRS to property placed in service after July 31, 1986, is unavailable to property that would be subject to the anti-churning rule if such property was placed in service after December 31, 1986.

The bill also clarifies that the transitional rule for sale-leasebacks applies to property that would have qualified for transitional relief in the absence of the sale-leaseback (e.g., property that is not placed in service by the original owner before the sale-leaseback) and to property where the original owner is a sublessee if all the other requirements for transitional relief are satisfied.

The bill also clarifies that modified ACRS applies to any real property, including a personal residence, that was acquired before January 1, 1987, and converted from personal use on or after such date to a use for which depreciation is allowable without regard to the rules for churning transactions.

For purposes of the general transitional rules, all members of the same affiliated group of corporations (within the meaning of section 1504 of the Code) filing a consolidated return are treated as one taxpayer.

For purposes of the binding contract rule, a purchase order will be treated as a binding contract even if not captioned as such, provided it is an order under a supply agreement for a specific number of properties based on the pricing provisions of the supply agreement. Clauses specifying settlement charges and adjustment charges to be paid by a buyer who purchases less than a minimum quantity of items under a volume supply agreement are not liquidated damages clauses unless the volume supply agreement defines them as the sole remedy of the seller and the sole liability of the buyer.

The bill makes other clarifying amendments to transitional rules of more limited application, including—but not limited to—clarifications that (1) the general rule for property financed with tax-exempt bonds does not override more specific transitional rules (such as the transitional rule for solid waste disposal facilities); and (2) the rule for finance leases of farm equipment incorporates the amendments made by the Tax Reform Act of 1984.

2. Investment tax credit

a. Termination of regular percentage (sec. 102(e) of the bill, sec. 211 of the Reform Act, and sec. 49 of the Code)

Present Law

For purposes of determining the amount of the investment tax credit ("ITC"), the regular percentage does not apply to property placed in service after December 31, 1985, subject to an exception for transition property. A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of ITC earned. Further, the ITCs allowable for transition property for taxable years beginning after June 30, 1987, and carryforwards to the first taxable year beginning after June 30, 1987, is reduced by 35 percent. For taxpayers with a taxable year that straddles July 1, 1987, ITCs are subject to a partial reduction that reflects the appropriate reduction for the portion of the taxable year after that date.[1] In the case of transition property that was subject to a full basis adjustment in respect of ITCs earned but unused, there is no upward basis adjustment if the ITCs are subject to further reduction when carried forward.

Explanation of Provision

The bill clarifies that a full basis adjustment is applied only with respect to the portion of an ITC attributable to the regular percentage. Further, if a credit for which a full basis adjustment was required (1) is recaptured, there will be an upward basis adjustment of 100 percent of the recapture amount, or (2) expires at the end of the carryforward period, a deduction will be allowed for 100 percent of the unused credit. Also, in applying the rule that coordinates the election to pass an ITC to a lessee and the basis adjustment, the required income inclusion is equal to 100 percent of the credit allowed to the lessee.

The bill also clarifies that the 35-percent reduction applies to ITC carryforwards used in a taxable year ending after June 30, 1987, irrespective of when the property with respect to which the credit is claimed was placed in service. For taxable years that straddle July 1, 1987, the bill clarifies that the amount added to carryforwards bears the same ratio to the carryforwards from the taxable year (before inclusion of the additional amount) as the reduction of the credit bears to the sum of the current year credit for the taxable year and the carryforwards to the taxable year, less the reduction of the credit under section 49(c)(3).

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[1] In the case of a corporation that is included in a consolidated return, the determination of whether the taxable year straddles July 1, 1987, is to be made by reference to the taxable year of the consolidated group, and not by reference to any short taxable year applicable to a corporation that is sold out of the group or a corporation that joins the group.

The bill clarifies that the order in which the components of the general business credit and the subcomponents of the investment tax credit arising during any taxable year are used generally is the order in which the credits are listed in the applicable Code section as of the close of the taxable year in which the credit is used. This ordering rule applies, for example, for purposes of determining the portion of a current year business credit or business credit carryforward that is subject to the 35-percent reduction. The bill repeals section 49(c)(5)(C) because the enactment of the general ordering rule renders unnecessary the ordering rule contained in section 49(c)(5)(C).

The bill also makes clarifying amendments to transition rules of limited application.

b. Elective 15-year carryback for steel companies and qualified farmers (sec. 102(f) of the bill and secs. 212 and 213 of the Reform Act)

Present Law

Certain steel companies can elect a 15-year carryback of 50 percent of ITC carryforwards in existence as of the beginning of a taxpayer's first taxable year beginning after December 31, 1985. The amount claimed as a payment against the tax for the first taxable year beginning on or after January 1, 1987, may not exceed the taxpayer's net tax liability for all taxable years during the carryback period (not including minimum tax liability, and reduced by the sum of certain allowable credits).

The amount of ITC carryforwards that are taken into account in determining the amount treated as a payment of tax is not taken into account under section 38 for any other taxable year. For example, if the available ITC carryforwards are $100,000 and the net tax liability during the carryback period is $40,000, then the amount of ITC carryforwards available for future taxable years would equal $20,000.

In the case of an electing corporation that is a member of an affiliated group of corporations that filed a consolidated tax return during any portion of the carryback period, the Act contemplates that the Internal Revenue Service will reduce the administrative burden of complying with this requirement—for example, by permitting the use of pro forma statements.

Explanation of Provision

The bill provides that rules similar to the rules of section 6425 shall apply to any overpayment resulting from the application of the provision for the elective 15-year carryback. In addition, the bill provides that any restructuring of a qualifying steel company does not affect the amount of the benefit that would otherwise be available to the company. Other conforming and technical changes are made.

B. Rapid Amortization Provisions

1. Trademark and trade name expenditures (sec. 102(i) of the bill, sec. 241 of the Reform Act, and sec. 167 of the Code)

Present Law

The Reform Act repealed the prior law provision that allowed taxpayers to elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration or defense of a trademark or trade name other than an expenditure which was part of the consideration for an existing trademark or tradename.

No amortization or depreciation deduction is intended to be allowed for trademark or trade name expenditures.

Explanation of Provision

The bill clarifies that no depreciation or amortization deduction is allowable for trademark or trade name expenditures.

2. Railroad grading or tunnel bores (sec. 102(i) of the bill, sec. 242 of the Reform Act, and sec. 167 of the Code)

Present Law

The Reform Act repealed the prior law provision which provided an election to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period.

No amortization or depreciation deduction is intended to be allowed for such expenditures.

Explanation of Provision

The bill clarifies that no amortization or depreciation deduction is allowable with respect to railroad grading or tunnel bores.

C. Real Estate Provisions

1. Tax credit for rehabilitation expenditures (sec. 102(k) of the bill and sec. 251 of the Reform Act)

Present Law

The Reform Act modified the rehabilitation credit generally for property placed in service after December 31, 1986. Exceptions were provided under transitional rules.

Explanation of Provisions

The bill clarifies that a rehabilitation need not be completed pursuant to a written contract that was binding on March 1, 1986, under the transitional rule that applies where property was acquired before March 2, 1986, or after that date pursuant to a written binding contract, and either (1) the required parts of the Historic Preservation Certification Application were filed, or (2) the lesser of $1 million or five percent of the qualified rehabilitation expenditures were incurred or required to be incurred before that date.

Under a provision included in the capital cost recovery section (discussed above), the bill clarifies that property eligible for a 25-percent credit under a transitional rule is not subject to the full basis adjustment requirement.

The bill also includes amendments with respect to other transitional rules of more limited application.

2. Tax credit for low-income rental housing (sec. 102(l) of the bill, sec. 252 of the Reform Act, and sec. 42 of the Code)

Present Law

The Reform Act provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years beginning either with the year a building is placed in service or one year thereafter (the credit period). Special rules apply to multiple building projects and for certain subsequent additions to basis.

New construction and rehabilitation expenditures for low-income housing projects placed in service in 1987 are eligible for a maximum nine percent credit, claimed annually for ten years. The acquisition cost of existing buildings and the cost of newly constructed buildings receiving other Federal subsidies (e.g., tax-exempt bond financing) placed in service in 1987 are eligible for a maximum four percent credit, also claimed annually for ten years. For buildings placed in service after 1987, these credit percentages will be adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits, and will be determined monthly for property placed in service in each month.

To qualify, a low-income housing project must satisfy a low-income set-aside requirement of either (1) 20 percent of the units occupied by persons having incomes of 50 percent or less of area median income, or (2) 40 percent of the units occupied by persons having incomes of 60 percent or less of such area income. A special additional requirement applies to projects satisfying a specified rent-skewing requirement.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. Qualified basis is the portion of the basis of the building (eligible basis) attributable to low-income housing units. Basis of units whose cost is disproportionate to that of the low-income housing units is excluded from eligible basis.

Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low", adjusted for family size. Section 8 payments are excluded in determining the amount of rent a tenant pays for purposes of this 30-percent limit.

To qualify for the credit, residential rental property must comply continuously with all requirements of the credit throughout a 15-year compliance period,[2] and, in the case of a credit for acquisition, may not have previously been placed in service for at least 10 years (the 10-year rule). A credit allocation from the appropriate State credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the new private activity bond volume limitation. Allocations are charged against the issuer's credit authority for the year of the allocation. Carryforwards of unused credit authority are not permitted.

Explanation of Provisions

Election to determine credit percentage early

The bill provides that, in addition to the method of determining the credit percentage under present law, for buildings placed in service by a taxpayer after 1987 the taxpayer (with the consent of the housing credit agency) may irrevocably elect to determine the credit percentage applicable to the building in advance of the building's placed-in-service date. Such an election will be binding for Federal income tax purposes on the taxpayer, the credit agency, and all successors in interest. The election must be made at the time a binding commitment is received by the taxpayer from the credit agency as to the housing credit dollar amount to be allocated to the building. In the case of a building financed with the proceeds of tax-exempt bonds for which no allocation from a credit agency is required, the election must be made by the taxpayer at the time the tax-exempt bonds are issued. The election must be filed with the Treasury Department by the fifth day of the month following the date the binding commitment is made or the bonds are issued. This election is applicable to credits attributable to new construction, rehabilitation, and acquisition expenditures.

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[2] Failure to satisfy this 15-year compliance period results in recapture of a portion of the credit. (A special rule for determining if a disposition is a recapture event applies to projects owned by certain large partnerships.)

Determination of gross rent

The bill provides that in determining the gross rent that may be paid by a tenant in a low-income unit, payments of State and local rental assistance programs comparable to section 8 of the United States Housing Act of 1937 are not considered. The bill further provides that this definition of gross rent is used for purposes of determining the rent that may be charged to a low-income tenant when applying the elective deep-rent skewing set-aside requirement for certain projects (*see* sec. 142(d)(4)). (The bill retains the definition of gross rent, which includes all rental assistance payments, used in the determination of the 3:1 rent skewing test also provided for those projects.)

The bill further provides that if a Federal rental assistance payment is made with respect to a low-income unit and the Federal statute (as in effect on October 22, 1986) governing that assistance payment requires that the gross rent paid by the occupants for that unit increase as the income of the occupants increases and that any such increase in the occupants' gross rent reduce equally the Federal rental assistance payment, then the gross rent paid by the tenant may exceed 30 percent of the applicable income limit to the extent required under the applicable Federal housing program statute.

Special rules for multiple building projects

The bill provides new rules for determining whether a building is part of a qualified low-income housing project in the case of multiple building projects. In such a project, buildings need not meet the minimum low-income set-aside requirement only by reference to the order that the buildings are placed in service. If within 12 months of the placed-in-service date of a prior building the project meets the set-aside requirement with respect to the first building and any subsequent buildings placed in service within the 12-month period, then the first building and included subsequent buildings are part of a qualified low-income project. Subsequent buildings not included in determining whether the project satisfies the set-aside requirement with respect to prior buildings have their own 12-month period before they are required to be included in the set-aside determination for the project.

De minimis exception to disproportionate cost limit

The bill permits a portion of the basis of housing units whose cost is disproportionate to that of the low-income units to be included in eligible basis. Unless otherwise provided by Treasury regulations, to be eligible for this exception, the cost per square foot of the disproportionate unit may not exceed by 15 percent the average cost per square foot of the low-income units. If cost differentials exceed 15 percent, the cost of the entire disproportionate unit must be excluded from eligible basis, as under present law.

The bill further provides that costs with respect to which an election was made by the taxpayer to deduct rehabilitation expenditures under prior law section 167(k) may not be included in eligible basis.

Exceptions to 10-year rule

The bill provides several exceptions to the restriction that buildings eligible for an acquisition credit may not have been previously placed in service within 10 years of the date of acquisition. Under these exceptions, a placement in service is disregarded if it is as a result of (1) death, (2) acquisition by a governmental unit or certain qualified 501(c)(3) or 501(c)(4) organizations whose acquisition of the property was at least 10 years after it was previously placed in service, or (3) a foreclosure occurring at least 10 years after the previous placed-in-service date, provided the property is resold within 12 months of such foreclosure.

Amendments affecting State credit authority

The bill provides that the State low-income housing credit authority must allocate credits to a building in the calendar year it is placed in service, unless (1) credits are allocated as the result of additions to qualified basis or (2) the authority makes a binding commitment no later than the last day of such year to allocate a specified amount of credits to the building in a later year. An allocation in a later calendar year pursuant to a binding commitment is counted against the State's credit authority limitation in such later year. Such later allocation does not defer the start of the credit period or the compliance period.

The bill further provides that, if for reasons unforeseen and beyond the control of the taxpayer which occur after an allocation of credit authority to a building, a building cannot be placed in service in the year for which an allocation was made, then upon approval by the Treasury Department, the credit allocation will be valid for that building if the building is placed in service in the first succeeding year after the year of the original allocation. This provision is effective beginning in 1988.

The bill provides that if a corporation is wholly owned by one or more qualified nonprofit organizations and such corporation materially participates in the development and operation of a qualified low-income project, the qualified nonprofit organization(s) will be treated as materially participating in the development and operation of such project for purposes of this section.

Recapture

The bill makes modifications to the rules regarding recapture of the credit. First, the bill provides that there will be no recapture for certain *de minimis* changes in the qualified basis by reason of changes in floor space of low-income housing units. Second, for partnerships more than 50 percent of which are owned by 35 or more natural persons or estates, the presence of a corporate partner will not exclude the partnership from a special rule under which recapture is determined at the partnership, rather than the partner, level.

Other amendments

The bill clarifies that, similar to other Federally subsidized loans, the proceeds of an issue of tax-exempt obligations used to finance a building may be excluded from eligible basis and the building will not be treated as federally subsidized.

The bill provides that tax-exempt financing or a below market loan used to provide construction financing for a building will not be treated as a Federal subsidy if such loan is repaid and any underlying obligation (e.g., tax-exempt bond) is redeemed before the building is placed in service.

The bill clarifies that designation of a *de minimis* portion of the gross rent of a low-income housing unit for use towards purchase of the unit by the tenant after expiration of the minimum compliance period for credit projects does not affect a housing project's eligibility for the low-income housing credit.

The bill modifies the at-risk provisions applicable to certain financing from qualified nonprofit organizations in the case of certain federally assisted buildings in which a security interest is not permitted by a Federal agency.

The bill provides certain information reporting requirements on owners of qualified low-income housing projects and imposes a penalty for failure to provide required information.

The bill clarifies that the sunset of credit authority to buildings placed in service after 1990 also applies to buildings financed with the proceeds of tax-exempt bonds not requiring an allocation of credit authority.

The bill provides that credits may not be carried back to taxable years ending before January 1, 1987.

The bill makes clarifying amendments to certain transitional rules of limited application.

The bill also corrects other minor clerical and technical errors.

III. CAPITAL GAINS AND LOSSES (SEC. 103 OF THE BILL)

1. Individual and corporate capital gains (sec. 103(a)-(c) of the bill, secs. 301-311 of the Reform Act, and various secs. of the Code)

Present Law

The Act repealed the prior law capital gains deduction for individuals and repealed the alternative tax rate on capital gains for corporations.

Explanation of Provision

The bill makes several conforming amendments to the repeal of the special capital gains treatment, including amendments relating to the computation of foreign source capital gain net income (sec. 904), the exclusion of capital gains by certain financial institutions in computing bad debt reserves under the taxable income method (sec. 593(b)), and the effective date for certain withholding changes. Further, the bill authorizes the Secretary to lower the withholding rate on gains from certain dispositions of U.S. real property interests by U.S. partnerships, trusts, or estates from 34 percent of the gain realized to 28 percent of the gain realized. It is expected that the Secretary will exercise this authority when the partner or beneficiary who is the taxpayer with respect to such gain is a foreign individual.

2. Incentive stock options (sec. 103(d) of the bill, sec. 321 of the Reform Act, and sec. 422A of the Code)

Present Law

Under present law, generally an employee is not taxed on the grant or exercise of an incentive stock option (as defined in section 422A(b)) and the employer is not allowed a deduction when the option is granted or exercised. The Act made several changes in the definition of an incentive stock option, including a change to provide that under the terms of the plan, the aggregate fair market value (at the time of grant of an option) of the stock with respect to which incentive stock options are first exercisable during any calendar year may not exceed $100,000.

Explanation of Provision

The bill provides that an option shall not be treated as an incentive stock option if, at the time the option is granted, the terms of the option provide that it will not be treated as an incentive stock option. Thus, an option that otherwise satisfies the requirements of section 422A(b) shall not be treated as an incentive stock option if, at the time of grant, the option is designated as not constituting an incentive stock option. In the case of an option granted after December 31, 1986, and before the date of enactment of this bill, an option will not be treated as an incentive stock option if the terms of the option are so amended before 90 days after the enactment of this bill.

The bill also deletes the $100,000 requirement added by the Act and instead provides that to the extent the aggregate fair market value (determined at the time the option is granted) of stock with repect to which options meeting the requirements of section 422A(b) are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000, then such options shall not be treated as incentive stock options. This rule is applied by taking options that meet the requirements of section 422A(b) and are exercisable for the first time in the calendar year into account in the order granted.

IV. AGRICULTURE AND NATURAL RESOURCE PROVISIONS (SEC. 104 OF THE BILL)

1. Treatment of discharge of indebtedness income of certain farmers (sec. 104(a) of the bill, sec. 405 of the Reform Act, and secs. 108 and 1017 of the Code)

Present Law

If an insolvent taxpayer realizes income from discharge of indebtedness, the income is excluded and the taxpayer's tax attributes and basis in property are reduced by the excluded amount (sec. 108). The exclusion is limited to the amount by which the taxpayer is insolvent. Reduction of attributes and basis occurs in the following order: net operating losses and carryovers, general business credit carryovers, capital loss carryovers, basis of property, and foreign tax credit carryovers.[1] The reduction in the basis of property is limited to the excess of the aggregate bases of the taxpayer's property over the taxpayer's aggregate liabilities immediately after the discharge (sec. 1017). If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds the available tax attributes and basis, the excess is forgiven, i.e., is not includible in income.

The Reform Act provides that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in the same manner as if incurred while the taxpayer was insolvent. Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. The gross receipts test is satisfied if 50 percent or more of the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which the discharged indebtedness occurs is attributable to the trade or business of farming. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements.

Any amount excluded from income under the special rules for qualified farm indebtedness must be used first to reduce tax attributes; then to reduce basis of property other than land used or held for use in a farming business; and finally to reduce the basis of land used or held for use in a farming business (sec. 1017).

Explanation of Provision

The bill clarifies that, for purposes of determining whether a taxpayer's indebtedness is qualified farm indebtedness, the gross receipts test is applied by dividing the taxpayer's aggregate gross receipts from farming for the three-taxable-year period preceding the taxable year of the discharge by the taxpayer's aggregate gross receipts from all sources for that period. In addition, the term "qualified person" is modified to include a Federal, State, or local government or agency or instrumentality thereof.

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[1] An election is provided under which the taxpayer may reduce basis in depreciable property before reducing net operating losses or other attributes.

The bill provides that, after reducing tax attributes in the order prescribed for insolvent taxpayers, amounts excluded from income under the qualified farm indebtedness provision may be applied to reduce basis in assets used or held for use in a trade or business or for the production of income (i.e., in "qualified property"). Basis reduction occurs first with respect to depreciable property, then with respect to land used in the business of farming, and then with respect to other qualified property.

The amount excluded under this provision may not exceed the taxpayer's total available attributes and basis in qualified property. Accordingly, to the extent there is unabsorbed discharge of indebtedness income after the taxpayer has reduced tax attributes and basis in qualified property, income will be recognized.

2. Retention of capital gains treatment for sales of dairy cattle under milk production termination program (sec. 104(b) of the bill and sec. 406 of the Reform Act)

Present Law

The Reform Act generally repealed the prior-law deduction for 60 percent of long-term capital gains of noncorporate taxpayers and the alternative tax for long-term capital gains of corporations. However, these amendments made by the Reform Act do not apply to any gain from the sale of dairy cattle under a valid contract with the United States Department of Agriculture under the milk production termination program to the extent such gain is properly taken into account under the taxpayer's method of accounting after January 1, 1987 and before September 1, 1987.

Explanation of Provision

The bill clarifies that the amendments made by the Reform Act with respect to capital gains do not apply to gain properly taken into account under the taxpayer's method of accounting during 1987 if the gain is with respect to a sale occurring under the program before October 1, 1987.

The transition provision applies only to gains that would be capital gains under the generally applicable provisions of the law. See, e.g., IRS Notice 87-26, 1987-10 IRB 16. (February 26, 1987). The transition provision does not recharacterize any payments that would not otherwise be capital gains.

3. Recapture of mining exploration expenses (sec. 104(c) of the bill, sec. 413 of the Reform Act, and sec. 1254 of the Code))

Present Law

The Reform Act provided that on the disposition of a mining property, the amounts deducted for mining development and exploration expenses are recaptured as ordinary income.

Explanation of Provision

The bill clarifies that the expensed mining exploration expenses that are included in income upon reaching the producing stage are not taken into account in determining the amount of recapture under this provision.

V. TAX SHELTERS: INTEREST EXPENSE (SEC. 105 OF THE BILL)
BILL)

1. Passive loss rules (sec. 105(a) of the bill, sec. 501 of the Reform Act, and sec. 469 of the Code)

Present Law

Present law, as amended by the Reform Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses (but not credits) are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized.

The provision applies to individuals, estates, trusts, and personal service corporations. A special rule prohibits the use of passive activity losses and credits against portfolio income in the case of closely held corporations. Losses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity (except as provided in regulations). Rental activities are defined as passive activities. Special rules provide that up to $25,000 of losses and (deduction equivalent) credits from rental real estate activities (those in which the taxpayer actively participates, with an exception for certain credits) are allowed against other income for the year. Losses from certain working interests in oil and gas property are not limited by the provision. The provision is effective for taxable years beginning after 1986. For certain pre-enactment interests in passive activities, the provision is phased in, and becomes fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Definition of portfolio income.—The bill clarifies that amounts not treated as from a passive activity include gain or loss that is not derived in the ordinary course of a trade or business, in the case of a disposition of property held for investment or property that generally produces income in the nature of interest, dividends, annuities or royalties. Gain or loss upon disposition of such property, where the gain or loss is derived in the ordinary course of a trade or business, is not automatically treated as not from a passive activity under this rule; rather, the general rules applicable to determining whether an activity is passive (e.g., whether the taxpayer materially participates) apply.

Dispositions.—The bill restates the rules applicable to the allowance of suspended losses upon a disposition of an interest in a passive activity.

In addition, the bill provides that, pursuant to regulations, to the extent necessary to prevent avoidance of the provision, income or gain from a passive activity in taxable years preceding the taxpayer's disposition of the activity is taken into account in determining the amount of the loss allowed against non-passive income upon disposition. Regulatory authority might appropriately be exercised, for example, in situations where passive activities produce taxable passive income in the initial years of an investment and then a loss upon disposition, such as where the investment is structured so that income is recognized in years prior to the allowance of related deductions.

The bill also makes several clerical amendments to the provisions relating to dispositions.

Special rule for rental real estate activities.—The bill clarifies the application of the active participation requirement for the allowance of up to $25,000 of losses (or deduction equivalent credits, where applicable) from certain rental real estate activities. The bill provides that the active participation requirement applies both in the year when the loss arose, and in the year when the loss is allowed under the $25,000 allowance. (The active participation requirement does not apply to low income housing or rehabilitation credits otherwise allowable under the $25,000 allowance.)

The bill also modifies the rule that an interest in an activity as a limited partner is not treated as an interest with respect to which the taxpayer actively participates. Under the bill, this rule applies except as otherwise provided in regulations.

The bill also clarifies the application of the passive loss phase-in rule to taxpayers with amounts allowed under the $25,000 rental real estate rule. Under the bill, the general loss disallowance rule of section 469(a) does not apply to the applicable percentage (for example, 65 percent in 1987) of the passive activity loss (or credit) attributable to pre-enactment interests. For this purpose, the portion of the passive activity loss (or credit) attributable to pre-enactment interests is the lesser of (1) the amount of the passive activity loss (or credit) which would be disallowed without regard to the phase-in rules or (2) the amount of the passive activity loss (or credit) which would be disallowed by taking into account only pre-enactment interests and by disregarding both the phase-in rules and the carryover of disallowed loss rules. Thus, for example, assume that in 1987 an individual with a full $25,000 exemption available had a $15,000 loss from pre-enactment rental activities in which the individual actively participated, a $15,000 loss from post-enactment rental activities in which the individual actively participated, and no other income or loss from passive activies. The individual is entitled to deduct $25,000 under the rental real estate rule of section 469(i) but is not entitled to a further deduction under the phase-in rules of section 469(m). This is because the amount of the passive activity loss attributable to pre-enactment interests is the lesser of (1) the amount disallowed without regard to the phase-in rules (i.e. $5,000) or (2) the amount which would be disallowed if only pre-enactment interests were taken into account (i.e. zero, since none of the $15,000 loss attributable to pre-enactment interests would be disallowed if only those interests were taken into account).

Coordination with rental use of dwelling.—The bill provides that income, deductions, gain or loss from rental use of a dwelling that the taxpayer uses as a residence (or from certain other business uses of a dwelling), for any taxable year in which deductions from such use are limited to the amount of income from such use under Code section 280A(c)(5), are not taken into account in determining the taxpayer's passive activity loss for the year. This provision eliminates the partial overlap of the deduction limitations imposed by section 280A(c)(5) and by the passive loss rules, principally in the circumstance of rental use of residences, and thus tends to simplify the application of these rules.

Affiliated groups.—The bill clarifies that for purposes of the passive loss rule, all members of an affiliated group that files a consolidated tax return are treated as one corporation, except as otherwise provided in regulations.

Trusts and estates.—The bill provides that if a trust or estate distributes its entire interest in a passive activity to the beneficiary of the trust or estate, the basis of the property immediately before the distribution shall be increased by the amount of the passive activity losses allocable to the activity. Gain or loss to the trust or estate and the basis of the property in the hands of the beneficiary will then be determined under the usual rules applicable under the Code.

Certain installment sales.—The bill treats as income from a passive activity, gain that is recognized in a taxable year beginning after 1986 from the disposition (in a taxable year beginning before 1987) of an interest in an activity that would have been treated as a passive activity within the meaning of section 469. Thus, under the bill, income from passive activities includes post-1986 gain from the pre-1987 installment sale of an activity that the taxpayer can show would have been treated as a passive activity if the passive loss rule had applied in the year of disposition.

The bill also makes clerical amendments to the definition provisions of the passive loss rule.

2. Investment interest limitation (sec. 105(c) of the bill, sec. 511 of the Reform Act, and sec. 163(d) of the Code)

Present Law

Under present law, in the case of noncorporate taxpayers, the deduction for investment interest expense is limited to the amount of net investment income for the year. Investment interest disallowed for the year is carried forward and treated as investment interest paid or accrued in the succeeding taxable year, and is allowable to the extent the taxpayer has net investment income in such year.

Investment interest is defined to include interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. For this purpose, property held for investment includes an interest in a trade or business activity that is treated as not a passive activity, but in which the taxpayer does not materially participate, within the meaning of the passive loss locable to portfolio income under the passive loss rule. Investment income is defined under present law as gross income from, and gain from the disposition of, property held for investment, to the extent such amounts are not derived from the ordinary conduct of a trade or business.

The provisions of the Reform Act affecting the investment interest limitation are phased in, so that the amended provisions become fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Investment interest.—The bill conforms the language of the definition of investment interest to the language of a related provision that allocates interest expense to portfolio income under the passive loss rule. Thus, under the bill, investment interest is that which is properly allocable to property held for investment. This change results in consistency in the language of the provisions allocating interest expense to the category of investment interest, and permits consistent application of a standard for allocation of interest. This change is not intended to suggest that the adoption of any particular method of allocation is required, but rather to give Treasury the ability to devise allocation rules as simple as possible consistent with the objectives of the provision. For example, the Treasury could consider rules relating to the securing of property to mitigate some of the complexities of tracing where simplicity is desirable, so that, for example, any interest on a loan secured by personal use property could be considered personal interest, and any interest on a loan secured by investment assets could be considered investment interest.

Investment income.—The bill conforms the definition of investment income to the definition of investment interest, by deleting the provision that amounts are treated as investment income only to the extent such amounts are not derived from the conduct of a trade or business.

Transitional rules.—The bill clarifies the operation of the phase-in rule. The bill provides that the amount of current year's investment interest disallowed during any taxable year in the phase-in period shall not exceed the sum of (1) the amount that would be disallowed if (a) the net investment income were increased by the ceiling amount (generally $10,000), (b) the reduction of net investment income by passive losses allowed under the passive loss phase-in rule did not apply, and (c) an interest in any activity that is not treated as passive and in which the taxpayer does not materially participate were not treated as held for investment; and (2) the applicable percentage for such year (e.g., 35 percent in 1987) of the amount which would be disallowed, under the fully phased-in investment interest limitation, over the amount determined under (1) above.

The bill also provides that any amount disallowed as a deduction as investment interest under prior law which would have been treated as investment interest paid or accrued in the taxpayer's first taxable year beginning after 1986 (under section 163(d)(2) of prior law) shall, to the extent attributable to a passive loss activity (e.g. interest incurred to purchase property subject to a net lease), be treated as a deduction under section 469 allocable to such activity and not as a deduction for investment interest. The passive loss phase-in rules shall not apply to such amount.

3. Personal interest limitation (sec. 105(c) of the bill, sec. 511 of the Reform Act, and sec. 163(h) of the Code)

Present Law

Under present law, as amended by the Reform Act, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year.

Present law provides that qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest is interest on debt secured by a security interest valid against a subsequent purchaser on the taxpayer's principal residence or a second residence of the taxpayer. Interest on such debt is deductible to the extent that the debt does not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements), plus the amount of qualified medical and qualified educational expenses, and to the extent the amount of the debt does not exceed the fair market value of the residence. A grandfather rule is provided in the case of debt incurred on or before August 16, 1986 and secured by the taxpayer's principal or second residence. Interest on such debt (reduced by any principal payments thereon) is generally treated as qualified residence interest, provided the amount of the debt does not exceed the fair market value of the residence.[1]

The personal interest limitation is phased in for taxable years beginning after 1986, and becomes fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Personal interest.—The bill conforms the language of the definition of personal interest to the language of related provisions (the passive loss rule and the investment interest limitation) under which interest expense may be allocated. Thus, the bill provides that personal interest does not include interest that is properly allocable to a trade or business. This change results in consistency in the language of several significant provisions under which interest is likely to be allocated, and permits consistent application of a standard for allocation of interest.

Refinancing of grandfathered debt.—The bill provides that interest on indebtedness secured by a qualified residence and incurred after August 16, 1986, to refinance grandfathered indebtedness (for example, to obtain a lower interest rate) will be treated as qualified residence interest if certain requirements are met.

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[1] The section on present law describes the provision as enacted in the Tax Reform Act of 1986. The Revenue Act of 1987 subsequently amended the limitations on the deductibility of qualified residence interest for taxable years beginning after December 31, 1987.

Indebtedness secured by the qualified residence and incurred after August 16, 1986 to refinance pre-August 17, 1986 grandfathered indebtedness qualifies under this rule to the extent that the principal amount of the refinancing does not exceed the principal amount of the pre-August 17, 1986 grandfathered indebtedness immediately before the refinancing. The refinancing exception will cease to apply, however, after the expiration of the period of the pre-August 17, 1986 indebtedness. Thus, if the pre-August 17, 1986 indebtedness was scheduled to be repaid at the end of 1992, interest on any refinancing of that debt, to the extent not otherwise deductible, will not be deductible for any period after 1992. Where the pre-August 17, 1986 debt was not amortized over its term (e.g., a "balloon" note), interest on any otherwise qualified refinancing of that debt will be deductible for the term of the first refinancing of the pre-August 17, 1986 indebtedness (but not for more than 30 years after that refinancing). A refinancing of indebtedness originally incurred after August 16, 1986 to refinance pre-August 17, 1986 grandfathered indebtedness (e.g., a second refinancing of such pre-August 17, 1986 debt) can also qualify under this rule subject to these requirements.

Thus, under the provision, the current balance (taking into account all amortization of principal) of the debt secured by the taxpayer's residence and incurred on or before August 16, 1986, that was grandfathered under the Reform Act, can be refinanced.[2]

Use of residence.—The bill clarifies the definition of a residence of the taxpayer that is treated as a qualified residence, interest on debt secured by which may be treated as deductible qualified residence interest. Under the bill, a residence may be treated as a qualified residence even if the taxpayer does not use it as such at least 14 days a year or 10 percent of the time it is rented (whichever is greater), provided that the residence is not rented at all during the year.

Unenforceable security interest.—The bill provides that interest on a loan secured by a recorded deed of trust, mortgage, or other security interest in a taxpayer's principal or second residence, in a State such as Texas where such security instrument will be rendered ineffective or the enforceability of such instrument will be otherwise restricted by State and local homestead or other debtor protection law such as the Texas homestead law, shall be treated as qualified residence interest, provided that such interest is otherwise qualified residence interest.

Transfer incident to divorce.—For taxable years beginning in 1987, the bill provides that in certain circumstances involving a transfer of a qualified residence between spouses incident to a divorce or legal separation, the basis limitation on debt, interest on which may be deductible, may be increased by the amount of secured indebtedness incurred by a spouse in connection with the acquisition of the other spouse's interest in the residence. The amount of such debt may not, however, exceed the fair market value of the interest in the residence that is being acquired.

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[2] These rules apply to taxable years beginning in 1987. The Revenue Act of 1987 amended the rules relating to the deductibility of qualified residence interest for taxable years beginning after December 31, 1987. That Act contains similar rules with respect to the refinancing of grandfathered debt (i.e. debt incurred on or before October 13, 1987).

Estates and trusts.—The bill allows interest paid or accrued by a trust or estate on indebtedness secured by a qualified residence of a beneficiary of a trust or estate to be treated as "qualified residence interest" if the residence would be a qualified residence (i.e., the principal residence or the second residence selected by the beneficiary) if owned by the beneficiary. The bill also clarifies that interest payable on the estate tax deferred under prior law section 6166A is not personal interest.

VI. CORPORATE TAX PROVISIONS (SEC. 106 OF THE BILL)

A. Corporate Tax Rate (sec. 106(a) of the bill, sec. 601 of the Reform Act, and sec. 15 of the Code)

Present Law

The Act revised corporate tax rates, effective for taxable years beginning on or after July 1, 1987. Under the Act, the maximum corporate tax rate under section 11 of the Code for such taxable years is 34 percent (rather than 46 percent, as under prior law). Income in taxable years that include July 1, 1987 (other than as the first date of such year) is subject to a blended rate under the rules specified in section 15 of the Code.

Certain other provisions of the Code require a determination of the maximum corporate tax rate under section 11 for a particular taxable year, for purposes other than imposing a tax by reference to such rate. Such provisions include the "high-taxed income" provisions of sections 904(d)(2)(F) and 954(b)(4) of the Code, which provide special treatment for certain income that is subject to foreign taxes exceeding the highest rate of tax under sections 1 or 11 of the Code (or 90 percent of such rate, in the case of section 954).

Explanation of Provision

The bill clarifies that any reference in the income tax provisions of the Code to the highest rate of tax imposed by section 1 [1] or section 11(b) of the Code (other than a provision imposing a tax by reference to such rate) shall be treated as a reference to the weighted average of the highest rates before and after the change determined on the basis of the respective portions of the taxable year before the date of change and on or after the date of the change. For example, in the case of a calendar year corporate taxpayer, the highest rate under section 11(b) for the calendar year 1987 would be 39.95% (181/365 x 46% and 184/365 x 34%).[2]

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[1] The reference to section 1 of the Code has no application to the non-corporate rate changes imposed by the Act because the Act does not subject the changes under section 1 to section 15 of Code. However, if any future legislation were to impose a rate change under section 1 that is subject to section 15, the provision would apply to such change.

[2] 181 is the number of days in calendar year 1987 prior to July 1; 184 is the number of days in the calendar year 1987 on or after July 1.

B. Dividends Received Deduction: Certain Dividends Received From a Foreign Sales Corporation (sec. 106(b) of the bill, secs. 611 and 612 of the Reform Act, and sec. 245(c) of the Code)

Present Law

The Act reduced to 80 percent the prior law 85 percent deduction that generally applied to dividends received by corporations. The Act did not affect the 100 percent dividends received deduction that applies in certain situations.

Under prior law, an 85 percent dividends received deduction was allowed to a domestic corporation for certain dividends attributable to qualified interest and carrying charges received or accrued by the payor corporation while it was a foreign sales corporation (FSC).

Explanation of Provision

The bill conforms the amount of the dividends received deduction for certain dividends attributable to qualified interest and carrying charges received or accrued by the payor corporation while it was a FSC to the general reduction, under the Act, of the 85 percent dividends received deduction to 80 percent. Accordingly, under the bill, the amount of the dividends received deduction for such dividends received in 1987 [2a] is reduced to 80 percent.

The bill makes certain other conforming and clerical amendments.

[2a] The Revenue Act of 1987 further reduced the dividends received deduction to 70 percent for dividends from less than 20 percent owned corporations. That Act corrected this error for dividends received after 1987.

C. Extraordinary Dividends Received by Corporate Shareholders (sec. 106 of the bill, sec. 614 of the Reform Act, and sec. 1059 of the Code)

Present Law

Under the Act, if a corporation receives an extraordinary dividend and has not held the stock subject to a risk of loss for a specified holding period (described below), the corporation must reduce its basis in the stock with respect to which the dividend was paid by the nontaxed portion of the dividend (i.e., the portion of the dividend eligible for the dividends received deduction). An extraordinary dividend is generally defined as one exceeding certain "threshold" amounts.

The Act provided a holding period requirement, under which basis reduction is required if the stock is not held subject to a risk of loss for more than two years before the dividend announcement date. The dividend announcement date is defined in the Act as the date on which the corporation declares, announces, or agrees to the payment of the dividend, whichever is the earliest.[3]

The Act also provided that certain distributions are treated as extraordinary dividends without regard to the recipient's holding period or the amount of the dividend. The distributions subject to this rule are any non pro-rata redemption and any redemption in partial liquidation constituting a dividend.

The Act provided a special relief provision applicable to certain qualifying preferred dividends. Under this provision, certain dividends that would otherwise require basis reduction because the more than two-year holding period is not met, may be eligible for a reduced amount of basis reduction or no basis reduction if the stock is either held for five years or if the dividends received do not exceed the dividends "earned," based on the stock's stated rate of return. This relief provision applies only in the case of certain preferred dividends on stock which provides for fixed dividends payable at least annually, with respect to which the taxpayer's actual rate of return does not exceed 15 percent. Furthermore, relief is available only to the extent the taxpayer's actual rate of return does not exceed the stated rate of return.

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[3] Although the amount of any fixed dividend on preferred stock is in a sense "announced" by the terms of the stock at the time the stock is acquired, all such fixed dividends on the stock, however long it is held, are not thus considered to be "announced or agreed to" within the 2-year period. However, the fixed dividends attributable to the first 2 years the preferred stock is held are considered "announced or agreed to" within the first two years, even though a payment date might be missed or there might otherwise be a delay in paying such dividends beyond the first 2 years to which they are attributable.

Similarly, if preferred stock provides for a cumulative dividend of a specified percentage of annual profits, the dividends attributable to the first 2 years profits are subject to the extraordinary dividends rule and basis reduction is required with respect to such dividends if the threshold percentage is exceeded, even if the dividends are not paid until the third year.

The basis reduction rules also apply in other situations that avoid the threshold amount or holding period requirements by deferring or staggering dividend payments.

The Act provided an exception under which no basis reduction is required in the case of an otherwise extraordinary dividend received with respect to stock of a corporation if: (i) the taxpayer has held the stock during the entire period such corporation was in existence, (ii) the only earnings and profits of the corporation were earnings and profits accumulated during such period, and (iii) the application of the exception is not inconsistent with the purposes of the extraordinary dividend provision.

The Act also provided an exception under which no basis reduction is required in the case of any qualifying dividend within the meaning of section 243(b)(1) of the Code. This provision was also intended to apply only where earnings and profits would directly or indirectly be solely attributable to the distributee shareholders in the case of distributions that constitute qualifying dividends within the meaning of section 243(b)(1). It was not intended that the extraordinary dividend provision duplicate any reductions in basis required under the consolidated return regulations with respect to dividend distributions (or deemed dividend distributions) between members of an affiliated group filing consolidated returns.

Under the Act, the Treasury Department is directed to prescribe such regulations as may be appropriate to carry out the purposes of the provision, including regulations providing for the application of the provision in the case of stock dividends, stock splits, reorganizations, and other similar transactions.

Explanation of Provision

The bill clarifies that the dividend announcement date, with respect to which the holding period requirement is tested, is the date on which the corporation declares, announces, or agrees to either the amount or the payment of the dividend, whichever is earliest. Thus, if the amount of a dividend is announced or agreed to within the two-year period, the fact that its payment may not have been announced or agreed to is irrelevant.

The bill clarifies that the nontaxed portion of any dividend that is a non pro-rata distribution or a partial liquidation distribution reduces basis, without regard to whether the two-year holding period requirement has been met.

The bill also clarifies the application of the special exception for dividends on stock that has been held during the entire existence of a corporation. This relief provision was intended to permit distributions without basis reduction, even through the distributions exceed the threshold percentage and are declared, announced or agreed to within the two-year holding period, only in those cases in which the earnings and profits of the corporation paying the dividend could not have been attributable, directly or indirectly, to any person other than the original shareholder receiving the distribution. For this purpose, earnings and profits are not considered attributable solely to such shareholder if any more than a de minimis part of such earnings and profits is derived, directly or indirectly, from any other entity in which the shareholder was not an original shareholder with an interest at least as great as such shareholder's original and continuing interest in the distributing corporation at the time of the distribution.

Thus, for example, the relief provision does not apply if any more than a de minimis part of the earnings and profits of the corporation paying the dividend were derived directly or indirectly from another corporation (e.g., through a dividend distribution, a transaction described in sec. 381, a sale of assets received in a section 332 liquidation or other carryover basis transaction, or by virtue of the consolidated return regulations increasing the earnings and profits of the corporation that is paying the dividend on account of earnings and profits of another corporation which is a subsidiary) in which the original shareholder did not at all times hold at least as great an interest as such shareholder's interest in the distributing corporation at the time of the distribution.

However, the fact that the distributing corporation directly or indirectly received de minimis amounts of earnings and profits from other entities (such as non-extraordinary dividends received from temporary portfolio investments of funds), would not generally be expected to preclude the application of the relief provision.

The bill clarifies that earnings and profits would be indirectly attributable to a person other than the shareholder receiving the distribution if they are attributable to transfers from or earnings and profits of any corporation that is not a "qualified corporation". A qualified corporation is one in which the shareholder receiving the dividend holds, directly or indirectly, at least as great an interest, throughout the entire existence of such corporation, as such shareholder has held throughout the period the corporation paying the dividend in question was in existence. In addition, a qualified corporation must have no earnings and profits which were earned by any person, or are attributable to gain on property which accrued during a period in which any person held such property, if the shareholder did not, throughout such corporation's or other person's existence, hold the requisite interest in such corporation or other person.

The bill similarly clarifies the exception for dividends that qualify under section 243(b)(1) of the Code, providing that such dividends do not qualify for the exception to the extent they are attributable to earnings and profits earned by a corporation during a period it was not a member of the affiliated group,[4] or attributable to gain on property which accrued during a period the corporation holding the property was not a member of the affiliated group.

It is expected that the application of the provision to distributions between members of an affiliated group filing consolidated returns will be consistent with the principles of the exceptions relating to qualifying dividends and dividends with respect to stock which the distributee has held throughout the distributor's entire existence. It is understood that, in most instances, the consolidated return regulations achieve results that are consistent with the purposes of the extraordinary dividend rules. For example, the regulations require a negative basis adjustment in the stock of a subsidiary to the extent the distribution represents preaffiliation earnings and profits of the subsidiary. A negative adjustment is not required with respect to all dividend distributions, however.

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[4] For this purpose, amounts received from a subsidiary of the distributing corporation that are distributed during a year in which it is affiliated with the distributee, but which represent earnings realized by the subsidiary (or by another corporation, such as a lower-tier subsidiary) during a year in which the subsidiary (or other corporation) was not affiliated with the distributee, will not be considered earned by the distributing corporation during an affiliation year.

It is recognized that the failure of the consolidated return regulations to require a negative adjustment to stock for dividend distributions received from a member is, in some situations, consistent with the principles of the extraordinary dividend provision. It is not intended that this provision will require a basis reduction in such situations. For example, a distribution during a consolidated return year out of earnings and profits accumulated during a prior year, throughout which the distributing corporation was affiliated with the distributee but did not join the distributee's consolidated return and not attributable to gain on property that accrued prior to affiliation, would not result in a reduction in the basis of the distributee's stock in the distributing corporation. Likewise, a distribution out of current year earnings to a member of the affilated group with which the distributing corporation files a consolidated return does not cause a basis reduction under the consolidated return rules. If such earnings are not attributable to gain on property accrued during a period the corporation holding the property was not a member of the group, the result in most instances would not be inconsistent with the purposes of this provision.

However, to the extent results produced under the consolidated return regulations are inconsistent with the purposes and principles of the extraordinary dividend provision, it is intended that a basis reduction may be required under this provision notwithstanding the fact that no reduction is mandated under the consolidated return regulations.

The bill clarifies that only fixed dividends (i.e., dividends that do not vary in amount from period to period) are eligible for the special relief provision for qualified preferred dividends.

The bill clarifies that the regulatory authority to carry out the purposes of the provision extends to cases where stock is held by pass-thru entities.

The bill deletes section 1059(d)(5) of the Code as deadwood.

D. Special Limitations on Net Operating Loss and Other Carryforwards

1. Value of loss corporation: Special rule in the case of redemption (sec. 106(d)(1) of the bill, sec. 621(a) of the Reform Act, and sec. 382(e) of the Code)

Present Law

After a more than 50 percent change in ownership, the taxable income of a loss corporation available for offset by pre-acquisition NOL carryforwards is limited by a prescribed rate times the value of the loss corporation's stock immediately before the ownership change. Debt thus reduces value for purposes of the limitation. Under a special rule, if a redemption occurs in connection with an ownership change—either before or after—the value of the loss corporation's stock is determined after taking the redemption into account. Also, redemptions are taken into account in determining whether a loss corporation has a built-in gain or loss. Further, the Secretary is authorized to prescribe regulations providing for the treatment of corporate contractions as redemptions.

Explanation of Provision

In lieu of regulatory authority, the bill extends the statutory rules for redemptions to other corporate contractions. The rule for redemptions was intended to apply to transactions that effect similar economic results, without regard to formal differences in the structure used or the order of events by which similar consequences are achieved. Thus, for example, the fact that a transaction might not constitute a "redemption" for other tax purposes does not determine the treatment of the transaction under this provision. As one example, a "bootstrap" acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, could generally be subject to the provision. This may include cases in which debt used to pay the old shareholders remains an obligation of an acquisition corporation or an affiliate, where the acquired loss corporation is directly or indirectly the source of funds for repayment of the obligation.

The bill also clarifies that if the old loss corporation is a foreign corporation, its value shall be determined taking into account only assets and liabilities treated as connected with the conduct of a trade or business in the United States.[5]

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[5] This provision relating to foreign corporations applies only to ownership changes occurring after June 10, 1987 (the date of introduction of the bill).

2. Definition of ownership change: Owner shift involving five-percent shareholder and equity structure shift (sec. 106(d)(2) of the bill, sec. 621(a) of the Reform Act, and sec. 382(g)(4)(C) of the Code)

Present Law

An ownership change occurs if the percentage of stock in a loss corporation owned by one or more five-percent shareholders increases by more than 50 percentage points relative to the lowest percentage of such stock owned by those shareholders during a testing period. The determination whether an ownership change has occurred is made after any owner shift involving a five-percent shareholder or any equity structure shift.

An owner shift involving a five-percent shareholder is defined as any change in the respective ownership of stock in a corporation that affects the percentage of stock held by any person who holds five percent or more of stock in the corporation before or after the change. An equity structure shift is defined as any tax-free reorganization within the meaning of section 368, other than a divisive "D" or "G" reorganization or an "F" reorganization. For purposes of these definitions, all less-than-five-percent shareholders are aggregated and treated as a single five-percent shareholder.

In determining whether an equity structure shift has occurred, the rule that aggregates less-than-five-percent shareholders is applied separately with respect to each group of shareholders of each corporation that is a party to the reorganization ("segregation rule"). Except as provided in regulations, the segregation rule applies in determining whether there has been an owner shift involving a five-percent shareholder; the regulatory authority in section 382(m) augments this rule for cases that involve only a single corporation. To the extent provided in regulations, transactions in which it is feasible to identify changes in ownership involving less-than-five-percent shareholders will be treated under the rules for equity structure shifts.

Explanation of Provision

The bill amends section 382(g)(4)(C) to clarify that rules similar to the segregation rule apply to acquisitions by groups of less-than-five-percent shareholders through corporations as well as other entities (e.g., partnerships), and in transactions that do not constitute equity structure shifts.

The regulatory authority in section 382(g)(3)(B)—to treat transactions under the rules for equity structure shifts—does not limit the scope of section 382(g)(4)(C). Section 382(g)(4)(C), by its terms, generally causes the segregation of the less-than-five-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction. Section 382(g)(3)(B) merely provides additional authority, as does section 382(m), for cases in which only one corporation is involved.

3. Special rules for built-in gains and losses and section 338 gains (secs. 106(d)(3) and (22) of the bill, sec. 621(a) of the Reform Act, and sec. 382(h) of the Code)

Present Law

If a loss corporation has a net unrealized built-in gain, the section 382 limitation for any taxable year ending within a five-year recognition period is increased by the recognized built-in gain for the taxable year. A net unrealized built-in gain is the amount by which the fair market value of a corporation's assets exceeds the aggregate adjusted basis of those assets immediately before an ownership change. The definition of a net unrealized built-in gain is inapplicable unless the amount of net unrealized built-in gain exceeds 25 percent of the value of the corporation's assets. Also, the definition is applied without taking account of any cash, cash items, or marketable security with a value that does not substantially differ from adjusted basis. The conference report refers to section 368(a)(2)(F)(iv) for the definition of cash items. That section includes receivables in the definition of cash items.

The section 382 limitation is increased by the excess of (1) gain recognized by reason of an election under section 338, over (2) the portion of such gain taken into account in computing recognized built-in gains for a taxable year. A recognized built-in gain is any gain recognized during the recognition period on the disposition of any asset, if the corporation establishes that the asset was held immediately before the ownership change, and to the extent the gain does not exceed the excess of the asset's fair market value over the adjusted basis on such date.

If an ownership change occurs during a taxable year, the section 382 limitation does not apply to the utilization of losses against the portion of the corporation's taxable income allocable to the period before the change. For this purpose, except as provided in regulations, taxable income realized during the taxable year is allocated ratably to each day in such year. Under the allocation rule, taxable income is computed without regard to recognized built-in gains and losses.

If a corporation has a net unrealized built-in loss, built-in losses recognized within a 5-year recognition period are subject to the section 382 limitation. The Act provides that the disallowed loss is carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of a net operating loss, and is subject to limitation in those years in the same manner as a pre-change loss.

Explanation of Provision

The bill clarifies the treatment of built-in gain if a section 338 election is made in connection with an ownership change, and if the 25 percent built-in gain threshhold was not met with respect to the ownership change, so that no post-change built-in gains would generally be allowed to increase the section 382 limitation. The bill provides that in such a case, the section 382 limitation for the post-change year in which gain is recognized by reason of the section 338 election is increased by the lesser of (i) the amount of net unrealized built-in gain (determined as of the date of the section 382 ownership change), computed without regard to the 25-percent threshold requirement, or (ii) the gain recognized by reason of section 338.

Also, regarding the allocation rule for the taxable year in which an ownership change occurs, taxable income is computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year, and without regard to recognized built-in losses to the extent such losses are treated as pre-change losses. That is, such gains or losses are disregarded for this purpose only to the extent they did not exceed the limitations on the total amount of recognized built-in gain or loss, as the case may be, for the year of recognition.

The amendment clarifies that under regulations any item of income which is properly taken into account during the recognition period but that is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Also, any amount which is allowable as a deduction during the recognition period but which accrued before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction. The amount of net unrealized built-in gain or loss shall be properly adjusted to include items of income attributable to periods before the change date and deductions which accrued before the change date. It is expected that under this provision, in computing net unrealized built-in gain or loss for purposes of determining whether the 25 percent threshold applies, receivables will be treated as cash items only if they were properly taken into account for tax purposes under the taxpayer's method of accounting prior to the date of the ownership change.

Finally, the bill clarifies that a recognized built-in loss that is disallowed retains its character as a capital loss or ordinary loss and is carried forward under the rules applicable to a loss of that character.

4. Testing period: Shorter period where all losses arise after three-year period begins (sec. 106(d)(4) of the bill, sec. 621 of the Reform Act, and sec. 382(i)(3) of the Code)

Present Law

The testing period for determining whether an ownership change has occurred generally is the three-year period preceding any owner shift involving a five-percent shareholder or any equity structure shift. After an ownership change, the testing period does not begin before the day following the first ownership change. If the corporation does not have a net unrealized built-in loss, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward.

Explanation of Provision

The bill clarifies that the testing period does not begin before the earlier of (1) the first day of the first taxable year from which there is a loss carryforward, or (2) the first day of the taxable year in which the transaction being tested occurs. Thus, where there is a current net operating loss for the taxable year in which an ownership change occurs, the testing period is determined by taking such taxable year into account.

5. Definitions of loss corporation, old loss corporation, and new loss corporation (secs. 106(d)(5), (10), and (21) of the bill, sec. 621(a) of the Reform Act, and secs. 382(k) and 382(l)(8) of the Code)

Present Law

The special limitations apply to the taxable income of any "new loss corporation." The term "loss corporation" is defined to include a corporation entitled to use a net operating loss carryover. A "new loss corporation" is a corporation that is a loss corporation after an ownership change. The same corporation may be both the old loss corporation and the new loss corporation.

An "old loss corporation" is a corporation with respect to which there is an ownership change, which was a loss corporation before the ownership change, or with respect to which there is a pre-change loss. A pre-change loss is any net operating loss carryforward of an old loss corporation to the taxable year ending with or in which the ownership change occurs, and the net operating loss of an old loss corporation for the taxable year in which the ownership change occurs (to the extent allocable to the period on or before the change date).

In determining whether an ownership change has occurred, the percentage of stock in the new loss corporation is compared to the lowest percentage of stock in the old loss corporation (or any predecessor) owned by a shareholder during the testing period.

Explanation of Provision

The bill clarifies that the definition of a loss corporation includes a corporation entitled to use a pre-change loss (that is, a net operating loss for the taxable year in which an ownership change occurs, as well as a net operating loss carryover to such year). Thus, for example, the definition of a new loss corporation includes a corporation that is entitled to use a net operating loss that was incurred in the taxable year in which an ownership change occurred.

Except as provided in regulations, any entity and any predecessor or successor of such entity is treated as one entity. As an example, if a corporation purchases 100 percent of the stock of an unrelated loss corporation, the loss corporation would become a new loss corporation. If the new loss corporation liquidates in a tax-free transaction pursuant to section 332 (so the new loss corporation's net operating loss carryforwards carry over to the acquiring corporation), the acquiring corporation—as successor—will continue to be treated as a new loss corporation.

The bill also modifies the definition of ownership change by eliminating the references to "old" and "new" loss corporations. This change merely eliminates circularity in the definition of ownership change, and is not intended to have any substantive effect.

6. Operating rules relating to ownership of stock (sec. 106(d)(6) of the bill, sec. 621(a) of the Reform Act, and sec. 382(l)(3) of the Code)

Present Law

In determining whether an ownership change has occurred, changes in the holding of certain preferred stock are disregarded, and the constructive ownership rules of section 318 are applied with several modifications.

One modification to the rules of section 318 relates to options and similar interests. Except as provided in regulations, the holder of an option is treated as owning the underlying stock if such presumption would result in an ownership change. Thus, the stock underlying an option or similar interest may be taken into account on and after the date on which the interest is acquired or later transferred. The subsequent exercise of an option is disregarded if the holder of the option has been treated as owning the underlying stock. On the other hand, if the holder of an option was not treated as owning the underlying stock, the subsequent exercise will be taken into account in determining whether there is an owner shift at time of exercise. Similarly, except as provided in regulations, a person is treated as owning stock that may be acquired pursuant to any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest, if such a presumption results in an ownership change.[6]

The Act does not provide rules for attributing stock that is owned by a government. For example, stock that is owned by a foreign government is not treated as owned by any other person. Thus, if a government of a country owned 100 percent of the stock of a corporation and, within the testing period, sold all of such stock to members of the public who were citizens of the country, an ownership change would result. Governmental units, agencies, and instrumentalities that derive their powers, rights, and duties from the same sovereign authority will be treated as a single shareholder.

Explanation of Provision

The bill clarifies that the constructive ownership rules of section 318 are applied only to "stock" that is taken into account for purposes of section 382. For example, assume a corporation owns both common stock and stock of a type that is not counted in determining whether there has been an ownership change (referred to as "pure preferred") in a holding company. The pure preferred represents 55 percent of the holding company's value. The holding company's only asset consists of 100 percent of the common stock in an operating subsidiary that is a loss corporation. The sale of the pure preferred would not constitute an ownership change because no stock in the loss corporation may be attributed through pure preferred. On the other hand, assume 100 percent of the stock in a loss corporation is transferred in a section 351 exchange, in which the loss corporation's sole shareholder receives pure preferred representing 51 percent of the transferee's value, and an unrelated party receives 100 percent of the transferee's common stock. Here, an ownership change would result with respect to the loss corporation. Similar rules apply where a loss corporation is owned directly or indirectly by a partnership (or other intermediary) that has outstanding ownership interests substantially similar to a pure preferred stock interest.

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[6] Thus, the type of rights to acquire stock that are subject to the option rule may extend beyond those rights that have been treated as options under section 318(a)(4) as applied for other purposes. For example, a right to acquire unissued stock in a corporation would (except as provided by regulations) be treated as exercised if an ownership change would result, without regard to how such right may have been treated under section 318(a)(4). The Treasury Department will exercise its regulatory authority to prevent the use of the option rule in appropriate cases—as one example, where options or similar interests are issued shortly after a corporation has incurred a de minimis amount of loss.

The bill also clarifies that the rule with respect to options extends beyond options that have been subject to section 318(a)(4).

7. Bankruptcy proceedings (secs. 106(d)(7), (8), and (18) of the bill, sec. 621(a) of the Reform Act, and sec. 382(l)(5) of the Code)

Present Law

The special limitations do not apply to an ownership change if the old loss corporation was under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change, and the shareholders and creditors of the old loss corporation own 50 percent or more of the value and voting power of the new loss corporation. However, the net operating losses of the corporation are reduced by any interest deductions on debt converted to stock for interest that was paid or accrued during the prior three years. Also, net operating losses are computed as if 50 percent of the amount that, but for section 108(e)(10)(B), would have been included in gross income, had been so included.

A new loss corporation may elect to forgo the special bankruptcy rule described above, in which case, the general rules will apply except the value used for purposes of computing the section 382 limitation will be the value of the new loss corporation immediately after the ownership change.

A modified version of the bankruptcy exception applies to a thrift involved in an equity structure shift that is a reorganization described in section 368(a)(3)(D)(ii), or any other equity structure shift or transaction to which section 351 applies that occurs as an integral part of a transaction involving a reorganization described in section 368(a)(3)(D)(ii). The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders, creditors, and depositors to retain a 20-percent (rather than 50-percent) interest. For this purpose, the fair market value of the outstanding stock in the new loss corporation includes deposits that become deposits of the new loss corporation.

Explanation of Provision

The bill clarifies that, for purposes of the 50-percent test, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock or a qualified creditor's interest that was held immediately before the ownership change. Thus, for example, stock received by a former stockholder for new consideration, such as the provision of funds to the corporation, a guarantee of corporate obligations, or any other consideration, is not taken into account. Similarly, stock purchased from other stockholders in the transaction is not counted. The bill also clarifies that stock received by a qualified creditor is taken into account only to the extent such stock was received in satisfaction of qualified indebtedness.

The bill clarifies the attribute reduction that occurs with respect to amounts that would be cancellation of indebtedness income. The amount of the reduction is 50 percent of the amount that (but for section 108(e)(10)(B)) would have been applied to reduce tax attributes under section 108(b), that is, the excess of the amount of cancelled debt over the fair market value of stock issued in satisfaction of the debt. The bill also clarifies that the amount of the debt outstanding for this purpose does not include previously accrued but unpaid interest that has already been deducted from net operating loss carryforwards under the rule requiring reduction for interest deducted during the three-year period prior to the ownership change.

The bill also clarifies that if an election to forgo the bankruptcy rule is made, the value of the new loss corporation will reflect any increase in value resulting from the surrender or cancellation of creditors' claims in the transaction.

Regarding qualified thrift reorganizations, the bill clarifies that the fair market value of the outstanding stock of the new loss corporation includes the amount of deposits in such corporation immediately after the change. Also, it is clarified that the voting power requirement will not cause a failure of the 20-percent test solely because deposits do not carry adequate voting power.

8. Effective dates (sec. 106(d)(11) of the bill and sec. 621(f) of the Reform Act)

Present Law

The provisions of the Act generally apply to ownership changes that occur on or after January 1, 1987. The Act states that its provisions apply to an ownership change following an owner shift involving a five-percent shareholder occurring after December 31, 1986, or following an equity structure shift occurring pursuant to a plan of reorganization adopted after December 31, 1986.

The earliest testing period under the Act begins on May 6, 1986. If an ownership change occurs after May 5, 1986, and before January 1, 1987, and the provisions of the Act do not apply, then the earliest testing period will not begin before the day following the date of such ownership change.

Under the general rules of section 382, if a public offering is performed by an underwriter on a "firm commitment" basis, the underwriter is treated as owning the stock for purposes of determining whether an owner shift involving a 5-percent shareholder has occurred.

Explanation of Provision

The bill clarifies that the provisions of the Act apply to ownership changes occurring after December 31, 1986. For purposes of this transition rule, and for purposes of determining when a new testing period starts under section 382(i), any equity structure shift pursuant to a plan of reorganization adopted before January 1, 1987 is treated as occurring when such plan was adopted.[7]

By treating equity structure shifts pursuant to plans of reorganization that were adopted before January 1, 1987 as occurring when the plan was adopted, the bill clarifies that no equity structure shift pursuant to a plan adopted after 1986, and no other owner shift involving a 5-percent shareholder occurring after 1986, is protected under the transition provisions, even though such shifts may occur before the completion of a pre-1987 plan of reorganization; i.e., such shifts are not grandfathered by virtue of the pre-1987 plan. If however, an ownership change occurs within the testing period prior to the end of 1986 when any equity structure shift pursuant to a pre-1987 plan is considered together with other pre-1987 owner shifts, that ownership change is grandfathered and a new testing period starts. Any equity structure shift pursuant to a plan adopted after 1986, and any post-1986 owner shift involving a 5-percent shareholder, that occurs before the completion of the pre-1987 plan of reorganization will count for purposes of determining when or whether a later ownership change occurs, under section 382(i).

If, applying the foregoing provisions and the rule in section 382(l)(3) (described below), an ownership change occurs immediately following an equity structure shift pursuant to a post-1986 plan of reorganization, or immediately following any other post-1986 owner shift involving a 5-percent shareholder, the ownership change is subject to the provisions of section 382 as amended by the Act.

The bill clarifies that the May 6, 1986, testing date applies for purposes of determining whether an ownership change occurred after May 5, 1986, and before January 1, 1987. For purposes of determining whether shifts in ownership occurred between May 5, 1986, and January 1, 1987, the rule in section 382(l)(3) for options and similar interests applies. Thus, in the case of such an interest issued on or after May 6, 1986, and before January 1, 1987, the underlying stock could be treated as acquired at the time the interest was issued. For this transition period, however, in addition to the Treasury Department's general regulatory authority under the rule in section 382(l)(3), the Treasury Department may provide for different treatment in the case of an acquisition of an option or similar interest that is not in fact exercised, as appropriate where the effect of treating the underlying stock as if it were acquired would be to cause an ownership change that would start a new testing period (and thus result in relief under the transitional rules). No inference is intended as to how pre-May 6, 1986 options or similar interests would be treated.

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[7] The bill thus clarifies that the transition rule for equity structure shifts pursuant to pre-1987 plans of reorganization is applicable even though such an equity structure shift may also be an owner shift involving a 5-percent shareholder.

The 1954 Code version of section 382(a), relating to nonreorganization transactions, has continuing application to any increase in percentage points of stock ownership to which the provisions of the Act do not apply by reason of any transitional rule—including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules that disregard ownership changes following or resulting from certain transactions. The 1954 Code version of section 382(b), however, does not apply to any reorganization occurring pursuant to a plan of reorganization adopted after December 31, 1986.

Any regulations that have the effect of treating a group of shareholders as a separate five-percent shareholder by reason of a public offering will not apply to any public offering before January 1, 1989, for the benefit of institutions described in section 591. Further, unless the corporation otherwise elects, an underwriter of any offering of stock of a corporation before September 19, 1986 (January 1, 1989 in the case of an offering for the benefit of an institution described in section 591) will not be treated as acquiring stock in the institution by reason of a firm commitment underwriting, but only to the extent such stock is disposed of no later than 60 days after the initial offering and pursuant to the offering.

9. Treasury Department regulatory authority with respect to property transferred in nonrecognition transactions (sec. 106(d)(23) of the bill, sec. 621(a) of the Reform Act and sec. 382(h)(9) of the Code)

Present Law

The Treasury Department is directed to prescribe such regulations as may be necessary to carry out the purposes of the loss limitation provisions where property held on the change date is transferred in a transaction where gain or loss is not recognized in whole or in part.

Explanation of Provision

The bill clarifies that the regulatory authority applies to cases where property held on the change date was acquired or is subsequently transferred in a transaction where gain or loss is not recognized in whole or in part. Thus, for example, it is clarified that property transferred in such a nonrecognition transaction prior to the date of the ownership change date is subject to the regulatory authority.

It is expected, as one example, that built-in gain with respect to property transferred in a nonrecognition transaction (including, for example, a tax-free reorganization as well as a section 351 contribution to capital) may in appropriate cases be disregarded for purposes of determining the amount of net unrealized built-in gain and for purposes of determining the addition to the section 382 limitation following an ownership change. It is expected that cases where such built-in gain will be disregarded may include transactions in which the value transferred to the corporation would be disregarded under section 382(l)(1) if the transaction had been a contribution to capital.

10. Treasury Department regulatory authority with respect to certain related corporations (sec. 106(d)(24) of the bill, sec. 621(a) of the Reform Act and sec. 382(m) of the Code)

Present Law

The Treasury Department has broad regulatory authority to prescribe any regulations necessary or appropriate to carry out the purposes of the loss limitation provisions.

Explanation of Provision

The bill clarifies that the regulatory authority is intended to include authority to provide appropriate adjustments to value, built-in gain or loss, and other items so that items are not taken into account more than once or omitted in the case of certain corporations under common ownership.

The bill defines such corporations under common ownership to include any group of corporations described in section 1563(a) (determined by substituting "50 percent" for "80 percent" each place it appears and without regard to section 1563(a)(4)).

E. Recognition of Gain or Loss on Liquidating Sales and Distributions of Property (*General Utilities*)

1. Limitations on recognition of loss (secs. 106(e)(1) and (2) of the bill, sec. 631(a) of the Reform Act, and secs. 336(d)(2) and 336(d)(3) of the Code)

Present Law

A corporation generally recognizes gain or loss on a sale or distribution of property, whether or not in liquidation. However, under the statute, loss is not recognized in certain circumstances (*see*, *e.g.*, sec. 336(d)).[8] One circumstance in which loss is not recognized involves the sale, exchange or distribution of property acquired by a liquidating corporation in a transaction to which section 351 applied or as a contribution to capital, if the acquisition of such property was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation. In these circumstances, the basis of the property for purposes of determining loss is reduced, but not below zero, by the excess of the adjusted basis of the property on the date of contribution over its fair market value on such date.[9] The statute provides that if the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by this provision is filed, the Secretary may prescribe regulations under which the loss may be recaptured in the year of liquidation, rather than requiring an amended return to be filed with respect to the year the loss was taken. The Act provides that property acquired by the liquidating corporation during the two-year period ending on the date of the adoption of the plan of liquidation shall, except as provided in regulations, be treated as part of such a plan subject to these provisions.[10]

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[8] Congress did not intend to create any inference regarding the deductibility of losses in liquidating or nonliquidating distributions or sales under other statutory provisions or judicially created doctrines, or to preclude the application of such provisions or doctrines where appropriate. *See, e.g.*, sec. 482 and Treas. Reg. sec. 1.482-1(d)(5); *National Securities Corp. Comm'r*, 46 B.T.A. 562 (1942), *cert. denied* 320 U.S. 794 (1943) (loss on sale by subsidiary of securities transferred by parent in nonrecognition transaction reallocated to parent, where purpose of transfer was to shift unrealized loss on securities to subsidiary); *Court Holding Co.* v. *U.S.*, 324 U.S. 321 (1945) (corporation treated as true seller of property distributed to shareholders and purportedly sold by them to third party); and *Gregory v. Helvering*, 293 U.S. 465 (1935) (in addition to meeting literal requirements of statute, transaction must have valid business purpose to qualify for nonrecognition).

[9] The effect of this rule of section 336(d)(2) is to deny recognition to the liquidating corporation of that portion of the loss on the property that accrued prior to the contribution, but to permit recognition of any loss accruing after the contribution. In the event that a transaction is described both in section 336(d)(1) (which denies loss accruing either before or after the contribution) and section 336(d)(2), section 336(d)(1) will prevail. This provision was not intended to override section 311(a). Thus, if property is distributed in a nonliquidating context, the entire loss (and not merely the built-in loss) will be disallowed.

[10] Although Congress recognized that a contribution more than two years before the adoption of a plan of liquidation might have been made for such a tax-avoidance purpose, Congress also

Continued

In the case of any liquidation to which section 332 of the Code applies, the Act provides that no loss shall be recognized in such liquidation.

Explanation of Provision

The bill clarifies that an acquisition of property by a corporation after the date two years before the date the corporation adopts a plan of complete liquidation (rather than merely during the two-year period ending on the date of the adoption of the plan) shall, except as provided in regulations, be treated as acquired as part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation.

The bill also clarifies that the provision denying recognition of loss to the distributing corporation in a section 332 liquidation is intended to apply to a distribution to the corporation meeting the control requirement of section 332 only if the distribution does not result in gain recognition to the distributing corporation, pursuant to section 337(a) or (b)(1). Thus, the provision denies loss recognition on a taxable distribution to minority shareholders in such a liquidation. If the section 332 liquidation is not described in section 337(b)(1) or (2) (for example, in the case of certain liquidations into a tax exempt parent corporation) the special loss disallowance provision of section 336(d)(3) does not apply. Such a transaction would be subject to any other applicable loss disallowance provisions, however.

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recognized that the determination that such purpose existed in such circumstances might be difficult for the Internal Revenue Service to establish and therefore as a practical matter might occur infrequently or in relatively unusual cases.

Congress intended that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property within two years of the adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises.

A clear and substantial relationship between the contributed property and the conduct of the corporation's business enterprises would generally include a requirement of a corporate business purpose for placing the property in the particular corporation to which it was contributed, rather than retaining the property outside the corporation. If the contributed property has a built-in loss at the time of contribution that is significant in amount as a proportion of the built-in corporate gain at that time, special scrutiny of the business purposes would be appropriate.

Congress expected that such regulations will permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation where prior law would have permitted the allowance of the loss and the clear and substantial relationship test is satisfied. In such circumstances, application of the loss disallowance rule is inappropriate assuming there is a meaningful (i.e., clear and substantial) relationship between the contribution and the utilization of the particular corporation form to conduct a business enterprise. If the contributed business is disposed of immediately after the contribution it is expected that it would be particularly difficult to show that the clear and substantial relationship test was satisfied. Congress also anticipated that the basis adjustment rules will generally not apply to a corporation's acquisition of property as part of its ordinary start-up or expansion of operations during its first two years of existence. However, if a corporation has substantial gain assets during its first two years of operation, a contribution of substantial built-in loss property followed by a sale or liquidation of the corporation would be expected to be closely scrutinized.

2. Election to treat certain stock sales and distributions as asset transfers (sec. 106(e)(3) of the bill, sec. 631(a) of the Reform Act, and sec. 336(e) of the Code)

Present Law

Under regulations prescribed by the Secretary, a corporation may elect to treat certain sales and distributions of subsidiary stock as asset transfers.

Explanation of Provision

The bill clarifies that Congress did not intend to require the election to be made unilaterally by the selling or distributing corporation. The bill thus provides that, under regulations prescribed by the Secretary, an election may be made to treat the certain sales and distributions of subsidiary stock as asset sales. Compare section 338(h)(10).

3. Treatment of distributing corporation where the 80-percent distributee is a tax-exempt organization (sec. 106(e)(4) of the bill, sec. 631(a) of the Reform Act, and sec. 337(b)(2) of the Code)

Present Law

Gain or loss is generally not recognized to the distributing corporation on certain distributions to a corporate parent that is an 80-percent distributee. However, if the 80-percent distributee is a tax-exempt organization, this rule does not apply unless the organization uses the property in an unrelated trade or business. Furthermore, if the organization does so use the property but subsequently disposes of the property or otherwise ceases to use it in an unrelated business, such disposition or cessation is a taxable event.

Explanation of Provision

The bill clarifies that the provision with respect to use in an unrelated trade or business was intended to apply to use in an activity the income from which is subject to tax under section 511(a).[11]

4. Basis adjustment in taxable section 332 liquidation (sec. 106(e)(6) of the bill and sec. 334 of the Code)

Present Law

A liquidating corporation recognizes gain or loss on certain liquidating distributions to which the rule of section 332(a) applies—for example, certain distributions to a tax-exempt or foreign corporation.

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[11] A distribution to a charitable trust would not qualify as a distribution to an 80-percent distributee (since only a corporation can qualify as an 80-percent distributee). Accordingly, the bill deletes the reference to section 511(b)(2) in section 337(b)(2).

Explanation of Provision

The bill clarifies that if gain is recognized on a distribution of property in a liquidation described in section 332(a) to a corporate distributee meeting the stock ownership requirements of section 332(b), a corresponding increase in the distributee's basis occurs.

5. Use of installment method by shareholders in certain liquidations (sec. 106(e)(6) of the bill, sec. 631(a) of the Reform Act, and sec. 453(h)(1)(B) of the Code)

Present Law

The Act retained prior law in providing that if, in a liquidation to which section 331 applies, the shareholder receives, in exchange for such shareholder's stock, certain installment obligations acquired by the corporation in respect of certain sales or exchanges of property, the receipt of payments under such an obligation by the shareholder shall be treated as the receipt of payment for the stock.

Explanation of Provision

The bill clarifies that, as under the law prior to the enactment of the Act, in the case of inventory the corporate sale or exchange must have been not only to one person but to one person in one transaction.

6. Certain distributions of partnership or trust interests (sec. 106(e)(7) of the bill, sec. 631 of the Reform Act, and secs. 386 and 311 of the Code)

Present Law

Under the Act, a corporation generally recognizes gain or loss on a liquidating distribution of property as if the corporation had sold the property to the distributee. A corporation also generally recognizes gain or loss on liquidating sales of property. Gain but not loss is generally recognized on a nonliquidating distribution. Distributions of partnership interests are thus also treated as sales, invoking the provisions of section 751 of the Code. A separate provision (sec. 386) also provides for the treatment of certain sales and distributions of partnership interests by corporations.

Explanation of Provision

The bill generally repeals section 386 of the Code as deadwood in light of the Act's amendments to sections 311, 336 and 337 of the Code. However, the bill restates, in section 311, the provision contained in present law section 386(d), that the Secretary may by regulations provide that the amount of gain recognized on a nonliquidating distribution of a partnership interest shall be computed without regard to any loss attributable to property contributed to the partnership for the principal purpose of recognizing such loss on the distribution (i.e., thereby reducing the gain otherwise recognized on the distribution and effectively recognizing a loss not permitted in a nonliquidating distribution).[12]

7. Losses on transactions between related taxpayers (sec. 106(e)(8) of the bill, sec. 631 of the Reform Act, and sec. 267 of the Code)

Present Law

No loss is generally allowed with respect to the sale or exchange of property between related taxpayers (other than a loss in case of a distribution in corporate liquidation) (sec.267(a)). The Act provided that certain losses at the corporate level may be denied in a liquidation under other Code provisions (sec. 336(d)).

Explanation of Provision

The bill clarifies that section 267(a) does not apply either to any loss of the distributee or to any loss of the distributing corporation in the case of a distribution in complete liquidation. Losses may be denied under other provisions of law or judicially created doctrine as under present law.

8. Distributions of property to corporate shareholders (secs. 106(e)(9), (10), and (11) of the bill, sec. 631 of the Reform Act, and sec. 301 of the Code)

Present Law

Section 301 of the Code provides generally that, in the case of a corporate distribution of property to a corporate distributee, the amount distributed is the lesser of (1) the fair market value of the property or (2) the adjusted basis of the property in the hands of the distributee, increased in the amount of gain recognized to the distributing corporation on the distribution. The basis of the property in the hands of the distributee is the same as the amount distributed.

If gain is recognized to the distributing corporation on a nonliquidating distribution, the holding period of the property in the hands of the distributee begins on the date of the distribution.

The Act provides that, on a nonliquidating distribution of property to a shareholder (including to a corporate shareholder), gain (but not loss) is recognized to the distributing corporation as if the property had been sold to the distributee at fair market value. On a liquidating distribution, gain or loss is generally recognized (though loss is not recognized in certain instances). Provisions of the Code other than section 301 generally provide for the basis of property received in a liquidation (secs. 331 and 334).

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[12] This provision is not intended to limit the operation of any present-law step-transaction or other doctrines that would disregard such loss. Such doctrines would also apply if a corporation with property on which loss would be disallowed under other Code provisions (such as sections 336(d)(1) or (d)(2)) contributed such property to a partnership to reduce the gain on distribution of the partnership interest and thus indirectly recognize the loss.

Explanation of Provision

Certain portions of section 301 are repealed as deadwood. Thus, section 301 of the Code is amended to provide that the amount distributed and the basis of property in the hands of a corporate distributee is the fair market value of the property. The holding period of such distributed property in the hands of the distributee begins on the date of the distribution, as under present law, but section 301(e) is not necessary to reach this result and is repealed.[13]

9. Certain transfers to foreign corporations (sec. 106(e)(13) of the bill, sec. 631(d) of the Reform Act, and secs. 367(a) and 367(e)(2) of the Code)

Present Law

Gain is recognized to a liquidating corporation in the case of a liquidating distribution to an 80-percent distributee that is a foreign corporation, unless regulations provide otherwise. It is expected that such regulations may permit nonrecognition if the potential gain on the distributed property at the time of the distribution is not being removed from the U.S. taxing jurisdiction prior to recognition.

Explanation of Provision

The bill clarifies that a transfer of property to a foreign corporation in a transaction that would otherwise qualify as a tax-free reorganization is treated in the same manner as a liquidating transfer of such property to an 80-percent foreign corporate distributee. Thus, in the case of a transfer of property described in section 361(a) or (b) (as amended by the bill) by a U.S. corporation to a foreign corporation, the provisions of section 367(a)(2) and (3) do not apply, and gain is recognized unless regulations provide otherwise. However, subject to such basis adjustments as shall be provided in regulations, this rule does not apply if the foreign corporate transferee is 80-percent controlled (within the meaning of section 368(c)) by a domestic corporation or by members of the same affiliated group of corporations within the meaning of section 1504. It is expected that regulations will provide this relief only if the U.S. corporate shareholder agrees to take a basis in the stock it receives in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporation's basis in such stock received pursuant to section 358, or (b) its proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. U.S. taxing jurisdiction over the built-in gain in such cases of U.S. corporate control is indirectly retained through the provisions of the Code relating to controlled foreign corporations. The requirement that certain U.S. corporate shareholders own at least 80 percent of the controlled foreign corporation stock assures that the bulk of the built-in gain will remain subject to

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[13] This change is made solely as deadwood and is not intended to alter the consequences of a distribution under the consolidated return regulations or any other provision of law or regulation.

U.S. taxing jurisdiction and justifies not imposing a partial tax on the portion of the gain not attributable to U.S. corporate shareholders. (Such a partial tax could present administrative difficulties in adjusting the basis of property in the hands of the transferee foreign corporation.)

10. Gain from certain sales or exchanges of stock in certain foreign corporations (sec. 106(e)(14) of the bill, sec. 631(d) of the Reform Act, and sec. 1248 of the Code)

Present Law

Gain from certain sales or exchanges of stock in certain foreign corporations is characterized as a dividend to the recipient under section 1248 of the Code. Section 1248(f) contains various provisions that under prior law caused income recognition and dividend treatment where a U.S. corporation sold, exchanged, or distributed the stock of a foreign corporation and gain and earnings and profits would not have occurred. This recognition was necessary because prior law treated certain liquidating sales and distributions and certain nonliquidating distributions by corporations as nonrecognition events.

Section 1248(d)(2) also contains a provision that was intended to assure that a foreign corporation that sold property in a liquidation would not experience an increase in earnings and profits to the extent that gain would not be recognized under section 337(a) of the Code on such a sale. This provision was originally written with reference to prior law section 337(a), which was repealed by the Act.

Under the Act, a distributing corporation generally recognizes gain on a liquidating or nonliquidating distribution of property with a fair market value in excess of basis as if the property distributed had been sold to the distributee at fair market value, and earnings and profits of the distributing corporation are accordingly increased. There are certain exceptions in the case of distributions that would be tax-free to a recipient under the tax-free reorganization provisions of the Code or under section 355 of the Code, and in the case of certain liquidating distributions to an 80-percent corporate distributee.

Explanation of Provisions

The bill amends section 1248(f) to conform to the changes under the Act that generally cause gain to be recognized, and earnings and profits to be created, on a liquidating sale or distribution or on a nonliquidating distribution, and that treat liquidating and nonliquidating distributions as sales or exchanges for this purpose. Section 1248(f)(1) under the bill applies only to certain distributions that are still nonrecognition events to the distributing corporation and are not treated as a sale by such corporation to the distributee—that is, distributions that would be tax-free to the recipient under the reorganization provisions of section 361(c) of the Code (as amended by the bill) or under section 355 of the Code and certain liquidating distributions to an 80-percent distributee. As under present law, section 1248(f)(2) excepts those situations in which the recipient U.S. corporation satisfies the stock ownership requirements of section 1248(f)(2) and is treated as holding stock for the period the stock was held by the distributing corporation.

It is contemplated that the Treasury Department may exercise its regulatory authority under section 1248(f) to provide that, in cases where a distribution that would be tax-free but for section 1248(f)(1) occurs within a controlled group, and section 1248(f)(2) does not otherwise apply, the recipient corporation may be required to take a carryover basis in the stock received (rather than a substituted basis under section 358, for example, in the case of a section 355 or 361 distribution) and section 1248(f)(1) will not apply to such distribution.

The bill repeals sections 1248(f)(3) and 1248(d)(2) as deadwood.

The bill makes certain other related clerical and conforming amendments.

11. Tax imposed on certain built-in gains of S corporations (sec. 106(f) of the bill, sec. 632 of the Reform Act, and sec. 1374 of the Code)

Present Law

A corporate level tax is imposed on gain that arose prior to the conversion of a C corporation to an S corporation ("built-in gain") that is recognized by the S corporation through sale, distribution, or other disposition within 10 years after the date on which the S election took effect. The total amount of gain that must be recognized by the corporation, however, is limited to the aggregate net built-in gain of the corporation at the time of conversion to S status.

The Act provided that the amount of recognized built-in gains taken into account for any taxable year shall not exceed the excess (if any) of 1) the net unrealized built-in gain, over 2) the recognized built-in gains for prior years beginning in the 10-year recognition period. Also, recognized built-in gain is not taxed in a year to the extent that it exceeds the taxable income of the corporation for the year computed as if the corporation were a C corporation.

Under the Act, the corporation may take into account certain subchapter C tax attributes in computing the amount of tax on recognized built-in gains. Thus, for example, it may use unexpired net operating losses to offset the gain and may use business credit carryforwards to offset the tax.

Explanation of Provision

The bill modifies the operation of the built-in gains tax so that it properly measures and segregates the tax on C corporation net built-in gains. Thus, net built-in gain for purposes of the tax is not reduced by post-conversion, non-built-in losses. However, built-in gain is reduced by items of loss or deduction that accrued prior to the first S corporation year. In the case of any subchapter S election made before March 31, 1988 (the date of introduction of the bill), the amount of net built-in gain subject to tax under section 1374 shall not exceed the corporation's taxable income.

The bill clarifies that the built-in gain provision applies not only when a C corporation converts to S status but also in any case in which an S corporation acquires an asset and the basis of such asset in the hands of the S corporation is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of the C corporation. In such cases, each acquisition of assets from a C corporation is subject to a separate determination of the amount of net built-in gain, and is subject to the provision for a separate 10-year recognition period. The bill clarifies that the Treasury Department has authority to prescribe regulations providing for the appropriate treatment of successor corporations—for example, in situations in which an S corporation engages in a transaction that results in carryover basis of assets to a successor corporation pursuant to subchapter C of the Code.

The bill clarifies that the amount of recognized built in gains taken into account for any taxable year shall not exceed the excess, if any, of 1) the net unrealized built-in gains at the time of the conversion, over 2) the recognized built-in gains for prior years beginning in the recognition period to the extent such gains were subject to the built-in gains tax.

The bill clarifies that, for purposes of this built-in gains tax under section 1374, any item of income which is properly taken into account for any taxable year in the recognition period but which is attributable to periods before the first taxable year for which the corporation was an S corporation is treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Thus, the term "disposition of any asset" includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish a taxpayer's right to claim or receive income. For example, the term "disposition of any asset" for purposes of this provision also includes the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

Similarly, the bill clarifies that amounts that are allowable as a deduction during the recognition period but that accrued before the first S corporation taxable year are thus treated as recognized built-in losses in the year of the deduction.

The bill clarifies that capital loss carryforwards may also be used to offset recognized built-in gains.

Finally, the bill makes certain clerical and conforming changes.

12. Distributions by S corporations (secs. 106(f)(8) 106(e)(22) of the bill and secs. 1363 (d) and (e) and sec. 453B(h) of the Code)

Present Law

Specific rules are provided for the distribution of appreciated property by S corporations, generally requiring the recognition of gain by the S corporation on distributions of appreciated property, with certain exceptions.

The distribution rules generally require recognition of gain on the distribution of any property (including installment obligations) as if the corporation had sold the property at fair market value.

Explanation of Provision

The bill provides that the distribution by an S corporation of an installment obligation with respect to which the shareholder is entitled to report the shareholder's stock gain on the installment method (by reason of section 453(h)) will not be treated as a disposition of the obligation. This rule will allow the shareholder to report the gain over the same period of years as if the amendments made by the 1986 Act had not been enacted. This special rule does not apply for purposes of determining the corporation's tax liability under section 1374. In addition, the character of the shareholder's gain shall be determined as if the corporate level gain had been passed through to the shareholder under section 1366.

The special distribution rules provided in Code section 1363(d) and (e) of the Code are repealed as deadwood. Thus, for example, it is clarified that, pursuant to section 1371 of the Code, the provisions of subchapter C of the Code apply to determine the recognition of gain and loss in the case of a distribution by an S corporation.

13. Regulatory authority to prevent circumvention of provisions (sec. 106(e)(5) of the bill, sec. 631 of the Reform Act, and sec. 337(d) of the Code)

Present Law

The Act provided that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made to Subpart B of the Code under the Act, including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations, including the consolidated return regulations and Part III of the Code, dealing with corporate organizations and tax-free reorganizations.

Explanation of Provision

The bill clarifies that the regulatory authority to prevent circumvention of the provisions of the Act extend to all the amendments made by subtitle D of Title VI of the Act. The bill also clarifies in connection with the built-in gain provisions of the Act that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out those provisions, including provisions dealing with the use of such pass-through entities, other than S corporations, as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this includes rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT or to a tax-exempt entity [14] in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

It is expected that Treasury shall also prevent the avoidance of the section through contributions of property with built-in loss to a corporation before it becomes an S corporation.

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[14] The Act generally requires recognition of gain if a C corporation transfers appreciated assets to a tax exempt entity in a section 332 liquidation. See Code section 337(b)(2).

It is also expected that the Treasury Department will prevent the manipulation of accounting methods or other provisions that may have the result of deferring gain recognition beyond the 10 year recognition period— for example, in the case of a C corporation with appreciated FIFO inventory that converts to S status and elects the LIFO method of accounting.

Section 704(c) of the Code generally requires that gain attributable to appreciated property contributed to a partnership by a partner be allocated to that partner; it is expected that this rule would generally prevent the use of a partnership to avoid the purposes of the amendments made by subtitle D of Title VI of the Act (for example, by attempting to shift the tax on C corporation appreciation to another party or to a non-C corporation regime). However, if and to the extent that partners might utilize allocation rules or other partnership provisions (including the so-called "ceiling rule" contained in the regulations under section 704(c)) to defer the recognition of built-in gain to a corporate partner by shifting the incidence of current gain recognition, it is intended that the Treasury Department may exercise its authority to prevent such results.

14. Transition provisions (sec. 106(g) of the bill and sec. 633 of the Reform Act)

a. Built-in gains of S corporations (sec. 106(g)(1) of the bill and sec. 633(b) of the Reform Act)

Present Law

The provisions of the Act (new Code section 1374) that impose a corporate level tax on certain built-in gains of C corporation assets after conversion to S status do not apply unless the first taxable year for which the former C corporation is an S corporation is pursuant to an election made after December 31, 1986. Prior law section 1374 will apply if Code section 1374 as amended by the Act does not apply.

Explanation of Provision

The bill clarifies that, for purposes of the transition provisions, if a corporation was a C corporation at any time prior to December 31, 1986, any "S" status of such corporation prior to its "C" corporation status is disregarded. Thus, the bill provides that (subject to the special small corporation transition rules of the Act) the built-in gains provisions apply to taxable years beginning after December 31, 1986, in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986.

The bill clarifies that a 34-percent tax rate applies to capital gain that is subject to prior law section 1374 in taxable years beginning after December 31, 1986.

b. General transition rule based on pre-August 1, 1986 action (sec. 106(g)(2) of the bill and sec. 633(c)(1)(B) of the Reform Act)

Present Law

The statute states that the amendments made by the Act do not apply to distributions or sales or exchanges by a corporation if 50 percent or more of the voting stock by value of such corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before such date and if such corporation is completely liquidated before January 1, 1988. The conference report states that this transition rule applies if "a majority" of the voting stock was acquired pursuant to such binding written contract.

In addition, the amendments made by the Act do not apply to any transaction described in section 338 with respect to any target corporation if a qualified stock purchase of such target corporation was made on or after August 1, 1986, pursuant to a written binding contract in effect before such date, and the acquisition date is before January 1, 1988.

Explanation of Provision

The bill clarifies that the transition rule applies if more than 50 percent (rather than 50 percent or more) of the voting stock is acquired pursuant to the binding written contract.

A clarification is made regarding the exception for a qualified stock purchase pursuant to a binding contract in effect before August 1, 1986. For purposes of this exception, a modification of a contract for the purchase of stock in more than one corporation that arises because of third party rights in the stock to be acquired (such as a right of first refusal), or because of the rules and rulings of government agencies or courts, is not intended to cause a contract to be deemed nonbinding, so long as the stock acquired was a part of the original contract. This clarification is not intended to create any inference regarding the meaning of binding contract in other contexts.

c. Transitional rules for certain small corporations (secs. 106(g)(3)-(g)(8) the bill and sec. 633(d) of the Reform Act)

Present Law

Special delayed effective dates are provided under the Act for certain closely held corporations that are limited in size. Corporations eligible for this rule are generally entitled to prior-law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. However, the special transitional rule requires the recognition of income on distributions of ordinary income property and short-term capital gain property. The statute states that recognition is also required with respect to any gain to the extent section 453B of the Code applies.

The Act provides that a corporation eligible for this rule may also become an S corporation for a taxable year beginning before

January 1, 1989. In such a case, the corporation is not subject to the new rules of section 1374 relating to built-in gains except with respect to ordinary income and short-term capital gain property.[15] The Act repealed section 333 of the Code. However, the amendments made by the Act do not apply to the applicable percentage of each gain or loss which would otherwise be recognized by reason of the Act. The applicable percentage is 100 percent if the applicable value of the qualified corporation is less than $5 million, and phases down to 0 percent if the applicable value of the corporation exceeds $10 million.

For distributions prior to January 1, 1989, qualifying corporations continue to be eligible for relief under the rules relating to nonliquidating distributions in effect prior to the Act (prior law sec. 311(d)(2)). However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The Act provides that a corporation is eligible for these special delayed effective dates if it was in existence on August 1, 1986, its value does not exceed $10 million, and more than 50 percent (by value) of the stock is held by 10 or fewer qualified persons. The conference report states that such 10 or fewer qualified persons must have held their stock for five years or longer.

The Act provides that a qualified person is an individual, an estate, or any trust described in clause (ii) or (iii) of section 1361(c)(2)(A) of the Code. Specified attribution rules are provided for purposes of determining ownership.

The Act provides that all members of the same controlled group (as defined in section 267(f)(1) of the Code) are treated as one corporation for purposes of the small corporation transitional rules.

The Act provides that the small corporation transition rules shall also apply in the case of a transaction described in section 338 of the Code where the section 338 acquisition date is before January 1, 1989.

Explanation of Provision

The bill provides that a qualified corporation eligible for the special delayed effective dates does not recognize gain on a distribution of installment obligations that are received in exchange for long-term capital gain property (including section 1231 property the disposition of which would produce long-term capital gain) where the distribution of such obligations would not have caused corporate level recognition under sections 337 and 453B(d)(2) as in effect prior to the Act. However, distributions of such installment obligations received in exchange for ordinary income property or short-term capital gain property do require the recognition of corporate level gain.

It is intended that a taxpayer that purchases the stock of a qualified corporation in a qualified stock purchase prior to January 1,

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[15] However, a corporation having a value in excess of $5 million (but not in excess of $10 million) is subject to a phase-out of this relief. Thus, in such circumstances new section 1374 applies to a portion of the long-term capital gain. Section 1374 as in effect before the Act will apply to any portion of the built-in long term capital gains not subject to new section 1374. In addition, to the extent a corporation is eligible for relief under the small corporation rule, a portion of any other long-term capital gain that would be covered by prior law section 1374 (whether or not built-in at the time of conversion) continues to be covered by that section.

1989, is entitled to apply prior-law rules (modified as in the case of actual liquidations) with respect to an election under section 338, even though in the hands of the acquiring corporation the qualified corporation no longer satisfies the stock holding period requirements and may not satisfy the size or shareholder requirements due to the size or shareholders of the acquiring corporation.

The bill clarifies that, although the Act repealed section 333 of the Code, in the case of a liquidating distribution to which section 333 of prior law would apply, a shareholder of a qualified corporation electing such treatment is entitled to apply section 333 without any phase-out of shareholder level relief under the Act. However, an increase in shareholder-level gain could result from an increase in corporate earnings and profits resulting from application of the corporate-level phase-out of relief.

The bill clarifies that for distributions before January 1, 1989, qualifying corporations continue to be eligible for relief under prior-law rules relating to nonliquidating distributions with respect to qualified stock, (prior law sec. 311(d)(2)), without regard to whether the corporation liquidates before January 1, 1989. However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The bill provides that a corporation is not a qualified corporation unless more than 50 percent (by value) of the stock of such corporation is owned (on August 1, 1986 and at all times thereafter before the corporation is completely liquidated) by the same 10 or fewer qualified persons who at all times during the 5-year period ending on the date of the adoption of the plan of liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or were treated as owning under the attribution rules) more than 50 percent (by value) of the stock of such corporation. This change to the statutory language of the Act, incorporating a holding period requirement, does not apply to nonliquidating distributions before March 31, 1988 (the date of introduction of the bill), to liquidating sales or distributions pursuant to a plan of liquidating adopted before March 31, 1988, or to deemed liquidating sales pursuant to an election under section 338 where the acquisition date under section 338 occurs before March 31, 1988. Also, for purposes of applying section 1374 in the case of a qualified corporation, the provision does not apply if the S election was filed before March 31, 1988.

Where stock passes to an estate, the holding period of the estate includes that of the decedent. Also, the "look-through" attribution rules that apply under this provision do not apply in the case of trusts qualifying under section 1361(c)(2)(ii) or (iii), just as they do not apply under the Act in the case of estates. Thus, stock held by such entities, like stock held by an estate, is to be treated as held by a single qualified person, so that the 10-shareholder test will not cease to be satisfied merely because a decedent's stock passes to such a trust. (In the case of other trusts holding stock, the "look-through" attribution rules apply to determine whether more than 10 qualified persons ultimately own the stock).

The bill also clarifies that the holding period of a decedent's estate (or a section 1361(c)(2)(A)(ii) or (iii) trust) is tacked with that of any beneficiary, as well as with that of the decedent, for purposes of determining the holding period. However, except in the case of beneficiaries who are treated as being "one person" with the decedent, once stock has been distributed to beneficiaries, the 10-shareholder requirement might fail to be satisfied due to an increase in the number of shareholders. Property acquired by reason of the death of an individual is treated as owned at all times during which the property was treated as owned (in addition to actually owned) by the decedent (as one example, property treated as owned by the decedent under the grantor trust rules, as well as property treated as owned by the decedent pursuant to attribution rules, would have a tacked holding period for this purpose).

In the case of indirect ownership through an entity, the rules described above are the only rules that apply to determine ownership and holding period. Thus, it is not intended that holding periods could otherwise be "bootstrapped" through analogy to or application of any provision of section 1223. For example, if a partnership owns all the stock of a corporation, a new partner who contributes other property to the partnership in exchange for a partnership interest is deemed under section 1223 to have a holding period in the partnership interest that includes such person's holding period for the property contributed. However, such a person would not be deemed thereby to have owned stock in the corporation that the partnership owned for any period prior to the time the person became a partner. In such cases, under the attribution and other holding period rules of the transitional provision a qualified person's holding period for the underlying stock is the lesser of (1) the period during which the entity held the stock in the qualified corporation, or (2) the period during which the qualified person held the interest in the entity. In other situations, the basic attribution and holding period rules of the transitional rule provision may provide a different result.[16]

The bill clarifies that the rule that all members of a controlled group of corporations (as defined in section 267(f)(1)) are treated as a single corporation applies solely for purposes of determining whether the corporation meets the size requirements for relief. Thus, it is clarified that it is not necessary for all members of a group that, in the aggregate, meets the size requirements for a qualified corporation, to liquidate before January 1, 1989, in order for the liquidation of one member of the group to qualify for relief. It is not intended that an S corporation be included as a member of the group unless such corporation was a C corporation for its taxable year including August 1, 1986 or was an S corporation that was not described in section 1374(c)(1) or (2) of prior law for such taxable year.

The bill also provides a rule to prevent the use of qualified corporations as conduits for the sale of assets by corporations that are not qualified. It is expressly provided that the transition rules do not apply where a principal purpose of a carryover basis transfer of an asset to a qualified corporation is to secure the benefits of the special transition rules. This provision is not intended to limit the application of the step transaction doctrine or other doctrines that would prevent the use of the transition rules. It is expected that a similar step transaction approach would be applied in the case of any transfer of assets to any corporation that qualified for transition under any of the other provisions of the Act, if a principal purpose of the transfer was to secure the benefit of transition for an otherwise non-qualified transaction.

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[16] For example, if a qualified person held stock of a corporation and subsequently contributed that stock to a partnership, the person's holding period would include the entire period the stock was held, directly or indirectly. The bill does not make any statutory change with respect to section 1223 since section 1223 does not by its terms operate to extend attribution periods, as explained above.

The bill makes certain other clerical and conforming changes.

F. Allocation of Purchase Price in Certain Sales of Assets (sec. 106(h)) of the bill, sec. 641 of the Reform Act, and sec. 1060 of the Code)

Present Law

Under the Act, in the case of an "applicable asset acquisition" both the buyer and the seller must allocate purchase price using the so-called "residual method" of allocation. Thus, both parties must use this method, as described in regulations under section 338 of the Code.[17] An applicable asset acquisition is any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for the assets.[18]

The Treasury Department is authorized to require information reporting by the parties to an applicable asset acquisition.

Explanation of Provisions

The bill provides that section 1060 applies to a distribution or transfer of an interest in a partnership to which section 755 applies, for purposes of determining the value of goodwill or going concern value (or similar items) under section 755.[19]

The bill provides that any information reporting required by the Treasury Department pursuant to this provision constitutes an information return for purposes of the penalty provisions of the Code.

The bill makes certain other clerical and conforming changes.

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[17] *See.* Temp. Treas. Reg. sec. 1.338(b)-2T. The Act endorsed the use of the residual method generally and applied the same method regardless of whether a transfer took the form of a stock transfer or an asset transfer. The Act did not preclude the Treasury Department from making changes to the final regulations, not inconsistent with the statutory purpose.

[18] A transaction may constitute an applicable asset acquisition even though section 1031 (relating to like-kind exchanges) applies to a portion of the assets transferred.

[19] The provisions of section 1060 of the Code are not intended to preclude the Internal Revenue Service from applying the residual method in other situations, including situations not involving an applicable asset acquisition, pursuant to its authority under other provisions of the Code.

G. Related Party Sales (sec. 106(i) of the bill, sec. 642 of the Reform Act, and sec. 453 of the Code)

Present Law

Installment sale treatment is not available for gain on a sale of property to a related party; rather, the seller must include all payments to be received in the year of the disposition. Contingent payments must also be included in the seller's income in the year of disposition. Under the Act, in the rare and extraordinary case in which the fair market value of contingent payments may not be reasonably ascertained, basis shall be recovered ratably. The so-called "open transaction" cost-recovery method of reporting sanctioned in *Burnet* v. *Logan*, 283 U.S. 404 (1931) may not be used.[20] The Act also provides that, in the case of such contingent payments, the purchaser may not increase basis by any amount until the seller has included such amount in income.

Related parties include a person and all entities more than 50 percent owned, directly or indirectly, by that person. Related parties also generally include entities more than 50 percent owned, directly or indirectly, by the same persons.

Explanation of Provisions

The bill clarifies that the requirement that the purchaser may not increase basis by any amount until the seller has included such amount in income applies not only to contingent payments as to which the fair market value may not be reasonably ascertained but also to any other amount in an installment sale of depreciable property between related parties.

The bill also provides that related parties, for purposes of these installment sale provisions, include partnerships that are more than 50 percent owned, directly or indirectly, by the same persons.

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[20] No inference was intended as to the viability of the cost recovery method under prior law.

H. Amortizable Bond Premium (sec. 106(j) of the bill, sec. 643 of the Reform Act, and sec. 171 of the Code)

Present Law

The deduction for amortizable bond premium is treated as interest, except as otherwise provided in regulations. Thus, for example, bond premium is treated as interest for purposes of applying the investment interest limitations.

The provision is effective for obligations acquired after October 22, 1986. For taxpayers who have elections in effect as of October 22, 1986, the statute provides that such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

Explanation of Provision

The bill provides that, except as otherwise provided in regulations, amortizable bond premium is treated as an offset to interest income on the bond, rather than as a separate interest deduction item subject to the various provisions relating to interest deductions. This provision of the bill applies in the case of obligations acquired after October 14, 1987; except that the taxpayer may elect to have the provision apply to obligations acquired after October 22, 1986 and on or before October 14, 1987.

The bill provides that, for taxpayers who have elections to amortize bond premium (under prior law) in effect as of October 22, 1986, such elections will apply to obligations acquired after that date (rather than to obligations issued after that date) only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

I. Certain Entity Not Taxed as a Corporation (Sec. 106(k) of the bill and sec. 106(k) of the Reform Act)

Present Law

The Act provided that a certain trust (Great Northern Iron Ore Trust) is not taxed as a corporation if specified conditions are satisfied, including nonexercise of certain powers contained in its trust instrument.

Explanation of Provision

The bill makes certain clarifications and corrections regarding the conditions that must be satisfied in order that the trust not be taxed as a corporation.

J. Regulated Investment Companies (secs. 106(l)-106(o) of the bill, secs. 651-657 of the Reform Act, and secs. 851, 852 and 4982 of the Code)

Present Law

Definition of regulated investment company

In order to qualify as a regulated investment company ("RIC"), an entity must derive at least 90 percent of its income from certain specified sources, including income that is derived with respect to its business of investing in stocks, securities or currencies (the "90-percent test"). By regulation, the Secretary of the Treasury may exclude from such income foreign currency gains not ancillary to the company's business of investing in stock or securities. In addition, a RIC must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months (the "30-percent test"). In the case of RICs that have so-called "series funds," the above tests are applied to each fund separately.

A corporation that is registered as a business development company under the Investment Company Act of 1940, is eligible to be a RIC.

Excise tax on undistributed income

Section 4982 imposes an excise tax on the undistributed income of RICs. In order to avoid paying this tax, a RIC generally must, during the calendar year, distribute 97 percent of its ordinary income for the calendar year and 98 percent of its capital gain net income for the one-year period ending on October 31 of such calendar year. The amount of capital gain net income is not reduced by the amount of any net operating loss of the RIC.

A RIC is deemed to have sufficient earnings and profits so that any distribution that is otherwise treated as a dividend by the RIC qualifies as a dividend. No additional earnings and profits are created, however, for redemption distributions that otherwise may qualify for a dividends paid deduction.

Taxation of RICs and their shareholders

In order to be taxed as a RIC, a RIC generally must distribute 90 percent of its taxable income. If a RIC is so taxed, its taxable income and net capital gain are taxed. To the extent provided in Treasury regulations, net capital gain is determined without regard to net capital loss attributable to transactions after October 31 and is treated as arising on the first day of the next taxable year.

Dividends declared by a RIC in December and made payable to shareholders of record on a specified date in that month are deemed to have been paid by the RIC, and received by its shareholders, on that date so long as they are actually paid before February 1 of the following year.

Explanation of Provisions

Definition of regulated investment company

The bill clarifies that income derived by a RIC from a partnership or trust shall be treated as derived with respect to the RIC's business of investing in stocks, securities or currencies, only to the extent that such income is attributable to items of income which would be derived with respect to that business if realized by the RIC in the same manner as by the partnership or trust.[21]

The bill provides that the Secretary of the Treasury may by regulation exclude foreign currency gains not directly related to the company's principal business of investing in stock or securities from qualifying under the 90-percent test. In addition, the bill provides that the 30-percent test applies to sales or dispositions of (1) stock or securities; (2) options, futures or forward contracts (other than those on foreign currencies); or (3) foreign currencies (or options, futures or forward contracts on foreign currencies) not directly related to the company's principal business of investing in stock or securities.

The bill modifies the application of the 30-percent rule in two situations. First, the bill provides that gains after the adoption of a plan of complete liquidation are not to be taken into account under the test if the RIC liquidates during the year in which the plan is adopted.

Second, under the bill, a fund that belongs to a series will not be disqualified under the 30-percent test by reason of sales resulting from, and occurring within five days of, abnormal redemptions if (1) the sum of abnormal redemptions on that day and on prior days during the taxable year exceed 30 percent of net asset value and (2) all funds in the series would meet the test if treated as a single RIC. Abnormal redemptions occur if net redemptions on any day exceed one percent of the fund's net asset value. Sales of stock or securities held less than 3 months will be deemed to have resulted from abnormal redemptions until the cumulative proceeds from such sales (plus cumulative net cash flow of the fund) exceed the amount of net redemptions on the day with abnormal redemptions. The net cash flow of a fund is the money received from any source, reduced by money paid out.

The bill provides that a corporation that elects to be treated as a business development company under the Investment Company Act of 1940 is eligible to be a RIC.

Excise tax on undistributed net income

The bill provides that, in determining a RIC's ordinary income under the excise tax imposed under section 4982, gain or loss attributable to a section 988 transaction which would properly be taken into account for the portion of the calendar year after October 31 is taken into account in the following year. In the case of a company electing to use a taxable year ending November 30, gain or loss attributable to a section 988 transaction which would properly be taken into account in December is taken into account in the following year.

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[21] This clarifies the operation of the general rule used to characterize items of income, gain, loss, deduction or credit includible in a partner's distributive share. See I.R.C. section 702(b).

Under the bill, for purposes of determining the amount that a RIC must distribute in order to avoid the excise tax under section 4982, a RIC may reduce its capital gain net income (as computed for purposes of section 4982) by the amount of any "net ordinary loss" but not below its "net capital gain." The "net ordinary loss" of the RIC is equal to the amount that would be the net operating loss of the RIC for the calendar year, with certain modifications. The "net capital gain" of the RIC for this purpose is the excess of the net-long term capital gain over the net short-term capital loss for the one-year period ending on October 31 of the calendar year (or such other one-year period used by the RIC for purposes of section 4892).

Under the bill, earnings and profits of a RIC are determined without regard to any net capital loss or net foreign currency loss attributable to transactions after October 31 of such year and with other adjustments provided in Treasury regulations. This treatment applies only to the extent that the amount distributed during the calendar year does not exceed the required distribution for such calendar year (as determined under section 4982 by substituting 100 percent for the percentages set forth therein). Such determination of earnings and profits does not apply to a RIC that (1) does not have a taxable year ending on October 31, and (2) except as provided in Treasury regulations, has not elected to use its own taxable year for purposes of computing the excise tax under section 4982.

The bill creates an exception to the excise tax under section 4982 when the RIC is owned predominantly by specified tax-exempt entities. The tax does not apply to any RIC for any calendar year if all its shareholders at all times during such year were qualified trusts or segregated asset accounts of insurance companies held in connection with variable contracts. Shares attributable to an investment of less than $250,000 made in connection with the organization of a RIC will not prevent the RIC from qualifying for this exception.

Taxation of RICs and their shareholders

The Secretary of the Treasury is granted authority in the bill to waive the distribution requirement applicable to RICs where failure to meet that requirement is due to distributions made in a prior year that were necessary to avoid imposition of the excise tax imposed under section 4982.

The bill grants regulatory authority to the Secretary of the Treasury to determine the taxable income of a RIC without regard to net foreign currency losses attributable to transactions after October 31 and to treat such losses as arising on the first day of the following year. This authority would not extend to a RIC which elects to use its taxable year for purposes of computing the excise tax imposed under section 4982.

In addition, under the bill, the amount of net capital gain would be determined without respect to net long-term losses occurring after October 31 and such net long-term capital losses would, for the purposes of determining capital gain dividend (and, to the extent provided in Treasury regulations, for purposes of determining taxable income) be treated as arising on the first day of the next taxable year.

The bill provides that dividends declared in October, November, or December and made payable to shareholders of record in such a month are deemed to have been paid by the RIC and received by its shareholders on December 31 of such year, so long as the dividends are actually paid during January of the following year.

K. Real Estate Investment Trusts (sec. 106(o)-106(s) of the bill, secs. 661-669 of the Reform Act, and secs. 856-857 and 4981 of the Code)

Present Law

In order for an entity to qualify as a real estate investment trust ("REIT"), at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property and "qualified temporary investment income." Qualified temporary investment income is income attributable to stock or debt instruments that is attributable to the temporary investment of new capital (as defined in sec. 856(c)(6)(E)(ii)). New capital includes amounts received in exchange for stock in the REIT other than amounts received pursuant to a dividend reinvestment plan.

Moreover, with certain exceptions, less than 30 percent of the gross income of a REIT must be derived from the sale or exchange of certain properties, including real property held for less than four years (the "30-percent test").

A REIT generally may not treat amounts as rents from real property if the determination of such amounts depends in whole or in part on the income or profits of any person from such property. An exception is provided where a REIT receives or accrues amounts with respect to real or personal property from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and such tenant receives or accrues only amounts that would be treated as rents from real property if received by the REIT. A similar rule is provided for interest.

In order to be taxed as a REIT, a REIT must generally distribute 95 percent of its taxable income. In addition, section 4981 imposes on REITs an excise tax on the excess of the required distributions over the "distributed amount" for the calendar year. Net income from foreclosure property is not a required distribution, but amounts attributable to such income are included in the "distributed amount."

Income from a shared appreciation provision of a loan held by a REIT that is secured by real property is treated as gain from the sale of the real property that secures the loan, effective for taxable years beginning after December 31, 1986.

Dividends declared by a REIT in December and made payable to shareholders of record on a specified date in that month are deemed to have been paid by the REIT, and received by its shareholders, on that date so long as they are actually paid before February 1 of the following year.

Explanation of Provisions

The bill clarifies that, for purposes of the definition of qualified temporary investment income, the term "debt instrument" has the same meaning as under section 1275(a)(1). For the same purposes, "new capital" is defined to include amounts received in exchange for certificates of beneficial ownership in the trust other than those received pursuant to a dividend reinvestment plan.

The bill provides that, for purposes of the 30-percent test, the REIT does not take into account in the year in which it is completely liquidated gain from the sale, exchange, or distribution of property after the adoption of a plan of complete liquidation. The bill also provides that the provisions of the Reform Act relating to the treatment of shared appreciation mortgages apply to taxable years beginning after December 31, 1986, but only with respect to obligations acquired after October 22, 1986.

The bill also clarifies that if a REIT receives or accrues amounts with respect to real or personal property from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and a portion of the amount that the tenant receives or accrues with respect to such property would be treated as rents from real property if received by the REIT, then the amounts received or accrued by the REIT from the tenant would not fail to be treated as rents from real property by reason of being based on the net income or profits of the tenant, to the extent that the amounts received or accrued by the REIT are attributable to amounts received by the tenant that would be treated as rents from real property if received by the REIT. A similar rule is provided for interest. In determining the portion of the rent (or interest) received from the tenant that may qualify as rent from real property (or interest) in these circumstances, allocation rules similar to those applicable under section 856(d)(4) (or section 856(f)(2)) are intended to apply.

Under the bill, for purposes of determining the amount that a REIT must distribute in order to avoid the excise tax under section 4981, a REIT may reduce its capital gain net income by the amount of any "net ordinary loss" of the REIT. The net ordinary loss of the REIT is the amount of the net operating loss of the REIT for the calendar year, with certain modifications. In addition, in order to assure a consistent treatment of net income from foreclosure property, dividends attributable to such property are excluded from the definition of "distributed amount" for purposes of the excise tax under section 4981. The Secretary of the Treasury is granted authority in the bill to waive the distribution requirement for taxation as a REIT where failure to meet that requirement is due to distributions necessary to avoid imposition of the excise tax.

The bill provides that dividends declared in October, November, or December and made payable to shareholders of record in such a month are deemed to have been paid by the REIT and received by its shareholder on December 31 of such year, so long as the dividends are actually paid during January of the following year.

The bill provides rules governing the treatment of interest rate swap or cap agreements, i.e., agreements which protect the REIT from interest rate fluctuations on variable debt incurred to acquire or carry real property. Such agreements are treated as securities under the 30-percent test and payments under them are treated as qualifying under the 95-percent test. No inference is intended regarding the treatment of interest rate swaps or caps under other provisions of the Code.

L. Real Estate Mortgage Investment Conduits (secs. 106(t)-106(v) of the bill, secs. 671-675 of the Reform Act, and secs. 860A-860G and 856 of the Code)

Present Law

Requirements for qualification as a REMIC

To qualify as a real estate mortgage investment conduit ("REMIC"), substantially all of an entity's assets must consist of "qualified mortgages" and "permitted investments" as of the close of the fourth month ending after the "startup day" and each calendar quarter ending thereafter (the "asset test").

A qualified mortgage is an obligation principally secured directly or indirectly by an interest in real property. It is unclear whether loans secured by stock in a cooperative housing corporation and debt instruments that are secured by other debt instruments, which other debt instruments are secured principally by interests in real property, may be treated as qualified mortgages. In general, a qualified mortgage must be transferred to a REMIC on or before the startup day, or purchased by the REMIC within three months of the startup day.

Permitted investments consist of cash flow investments, qualified reserve assets, and foreclosure property. A qualified reserve asset is intangible property which is held for investment and is part of a qualified reserve fund. A qualified reserve fund is any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages.

Foreclosure property is property that would be foreclosure property if acquired by a real estate investment trust ("REIT") and which is acquired in connection with the default of a qualified mortgage. Property ceases to be foreclosure property on the date which is one year after the date the REMIC acquired such property. No tax is imposed on the REMIC with respect to income from foreclosure property.

All interests in the REMIC must be "regular interests" or "residual interests." A regular interest is an interest the terms of which are fixed on the startup day, which unconditionally entitles the holder to receive a specified principal amount, and which provides that interest amounts are payable based on a fixed rate (or a variable rate to the extent provided in Treasury regulations). A residual interest is any interest that is so designated and that is not a regular interest in a REMIC. The startup day is any day selected by the REMIC that is on or before the first day on which regular interests in the REMIC are issued.

Taxes on the REMIC

A REMIC is required to pay a tax equal to 100 percent of its net income from prohibited transactions. With certain exceptions, a disposition of a qualified mortgage is a prohibited transaction. No exception is provided for the repurchase of a defective mortgage in lieu of its substitution. In addition, any disposition of a cash flow asset is treated as a prohibited transaction.

Taxation of holders of residual interests

Generally, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of such REMIC for each day during which he held such interest. With certain exceptions, the taxable income of a REMIC is determined in the same manner as in the case of an individual.

The taxable income of any holder of a residual interest in a REMIC for any taxable year shall not be less than the excess inclusion for that year. Thrift institutions are excepted from this requirement and therefore may offset excess inclusions with net operating losses. The effect of these rules on affiliated groups is unclear.

If a tax-exempt organization subject to the tax on unrelated business income holds a residual interest, its excess inclusion is treated as unrelated business taxable income. The tax consequences of the holding of a residual interest by a tax-exempt organization which is not subject to the tax on unrelated business taxable income are uncertain.

If a residual interest in a REMIC is held by a REIT, the excess of aggregate excess inclusions over REIT taxable income is allocated to the REIT shareholders in proportion to the dividends received by such shareholders and the amount so allocated is treated as an excess inclusion with respect to each such shareholder.

Signing of return

For procedural purposes, a REMIC is treated as a partnership, and holders of a residual interest are treated as partners. As such, the REMIC is required to file certain returns, which must be signed by a holder of a residual interest.

Other provisions

An interest in a REMIC is treated as a qualifying asset for purposes under sections 593(d)(4), 856(c)(6)(E) and 7701(a)(19)(C)(xi) in the same proportion that the assets of the REMIC would be treated as qualifying for those purposes. In addition, an entire interest in a REMIC is treated as a qualifying asset under these provisions if 95 percent of the assets in the REMIC would so qualify (the "95-percent test"). The application of the 95-percent test to tiered REMICs is unclear.

Explanation of Provisions

Requirements for qualification as a REMIC

Residual interests held by disqualified organizations.—To qualify an entity as a REMIC, the bill provides that there must be reasonable arrangements designed to ensure that residual interests in it are not held by disqualified organizations.[22] Such arrangements include restrictions in the governing instruments of the entity prohibiting disqualified organizations from owning a residual interest in the REMIC and notice to residual interest holders of the existence of such restrictions. Such arrangements would not be deemed to have been made if it is contemplated when the REMIC is formed that disqualified organizations will own residual interests in it.

In addition, to qualify as a REMIC, the entity must make available information necessary for the application of the tax on certain transfers of residual interests.[23] Such information would include a computation of the present value of the excess inclusions of a residual interest transferred to a disqualified organization. The REMIC would not fail to satisfy the qualification requirement simply because it charged the person liable for the tax a reasonable fee for providing such information. The failure of such a person to pay such fee will not, however, affect the obligation of the REMIC to provide such information to the Internal Revenue Service.

Application of asset test.—The bill makes the asset test continuous after the third month. Thus, after the third month, substantially all of a REMIC's assets must, at all times, consist only of qualified mortgages and permitted assets. The asset test, however, does not apply during the qualified liquidation period.

Qualified mortgage.—The bill clarifies the definition of a qualified mortgage by requiring that the mortgage be principally secured directly by an interest in real property. Thus, under the bill, debt instruments that are secured by other debt instruments, which other debt instruments are secured principally by interests in real property, may not be treated as qualified mortgages.[24] The bill provides, however, that loans secured principally by stock in a cooperative housing corporation may be treated as qualified mortgages. The bill also provides that, to be treated as a qualified mortgage, an obligation must be transferred to a REMIC on the startup day in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months of the startup day pursuant to a fixed-price contract in effect on the startup day.[25]

Qualified reserve fund.—Under the bill, the definition of a qualified reserve fund is broadened to include reasonably required reserves to provide for full payment of amounts due on regular interests in the event of lower than expected returns on cash flow investments.

Regular interest.—Under the bill, the definition of regular interest is broadened to encompass interests which entitle the holder to interest payments consisting of a specified portion of the interest payments on qualified mortgages if such portion does not vary during the period the regular interest is outstanding. The broadening of the definition is intended to permit such interests in a REMIC to qualify as a regular interests even if the amount of interest is disproportionate to the specified principal amount.

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[22] For the definition of a disqualified organization, see discussion of tax on certain transfers of residual interests, below.

[23] See "Tax on certain transfers of residual interests," below.

[24] A regular interest in a REMIC, which is treated as a debt instrument for Federal income tax purposes, may be treated as a qualified mortgage, however.

[25] For this purpose, mortgages may be considered to be purchased pursuant to a fixed-price contract despite the fact that the purchase price may be adjusted where the mortgages are not delivered by the seller on the startup day, provided that the adjustment is in the nature of damages for failure to deliver the mortgages rather than as a result of fluctuations in market price between the startup day and the date of delivery.

The bill also provides that a regular interest in a REMIC must be issued on the startup day with fixed terms and must be designated as a regular interest. Under the bill, a residual interest also must be issued on the startup day. Under the bill, the startup day is any day in which the REMIC issues all of its regular and residual interests. In addition, to the extent provided in Treasury regulations, all interests issued and all transfers to the REMIC during any period (not exceeding 10 days) permitted in such regulations may be treated as occurring on the startup day.

Taxes on the REMIC

The bill provides that the repurchase of a defective mortgage in lieu of substitution is not treated as a prohibited transaction even if it occurs more than two years after the startup day. It also provides that the sale of cash flow investments required to prevent defaults on a regular interest where the threatened defaults result from a default on one or more qualified mortgages, or to facilitate a "clean-up call" is not treated as a prohibited transaction.

In addition, if any property is contributed to the REMIC after the startup day, the bill imposes a tax on the REMIC for the taxable year in which the contribution is received equal to 100 percent of the amount (by value) of such contribution. Exceptions to this tax are made for cash contributions made to facilitate a clean-up call or a qualified liquidation, made during the three months following the startup day, or made to a qualified reserve fund by a holder of a residual interest. Also excepted are cash payments in the nature of a guarantee and cash contributions as permitted in Treasury regulations.

A clean-up call is the prepayment of the remaining principal balance of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. It typically occurs when there is no more than a small percentage of the particular class of interests outstanding. It does not include the retirement of a class undertaken in order to profit from a change in interest rates.

Under the bill, a REMIC is subject to tax at the highest rate applicable to corporations on its "net income from foreclosure property." Net income from foreclosure property is the amount that would be the REMIC's net income from foreclosure property under section 857(b)(4)(B) if the REMIC were a REIT. Thus, if a REMIC acquires foreclosure property and receives amounts with respect to such property that would not be treated as certain types of qualifying income if received by a REIT, then the REMIC would be subject to tax on such amounts. Property eligible for treatment as foreclosure property would be so treated for a period of two years, with possible extensions. The amount of the REMIC's taxable income is reduced by any tax paid with respect to income from foreclosure property.

Taxation of holders of residual interests

Under the bill, the Secretary of the Treasury is granted regulatory authority to determine the taxable income of a REMIC in a manner other than as in the case of an individual. It is intended that this authority be used to permit the REMIC generally to treat bad debts as other than nonbusiness bad debts and, as appropriate, to permit a deduction for capital losses without limitation, but not to take the dividends received deduction. It is also intended that the Secretary of the Treasury use its authority to prevent individuals from using the REMIC election to circumvent their limitations on bad debt and capital loss deductions.[26]

The bill clarifies that all members of an affiliated group are treated as one taxpayer for purposes of the rule requiring that taxable income be no less than excess inclusions. Thus, net operating losses of the group cannot be used to offset excess inclusions. The bill also clarifies that, except as provided below, the exception for thrift institutions is available only if the institution itself, and not any affiliate of the institution, holds the residual interest. Thus, net operating losses of a thrift institution may offset excess inclusions only in the case of residual interests held by the thrift institution.

Notwithstanding the above, a thrift and a qualified subsidiary will be treated as a single corporation under the excess inclusion rule. Consequently, losses of the thrift institution may offset excess inclusions of the subsidiary. A qualified subsidiary of a thrift institution is any corporation all the stock and substantially all of the debt of which is directly owned by the thrift institution and which is organized and operated exclusively for the purpose of organizing and operating one or more REMICs.

Excess inclusions attributable to residual interests held by regulated investment companies ("RICs"), common trust funds, and subchapter T cooperatives will be allocated to shareholders of such entities using rules similar to those applied to a REIT and its shareholders.

The bill also clarifies that, with respect to a variable contract (within the meaning of sec. 817), there is no adjustment in the reserve of an insurance company taxable under subchapter L of the Code to the extent of any excess inclusion. Thus, the insurance company would be taxed currently on the excess inclusion.

Tax on certain transfers of residual interests

The bill imposes a tax on any transfer of a residual interest in a REMIC to a disqualified organization. The amount of the tax is equal to the top corporate rate times an amount (determined under Treasury regulations) equal to the present value of the total anticipated excess inclusions with respect to such interests for periods after such transfer. It is expected that such Treasury regulations will provide that the amount of the anticipated excess inclusions will be determined based on events which have occurred up to the time of the transfer and the prepayment assumption used to determine the accrual of original issue discount under section 1272(a)(6). It is anticipated that the present value of such amount will be determined on the basis of the applicable Federal rate.

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[26] It also is intended that the income from residual interests be treated as portfolio income for purposes of the passive loss rules.

The bill defines a disqualified organization as the United States, any State or political subdivision thereof, any foreign government, any international organization or agency or instrumentality of the foregoing; any tax-exempt entity (other than a section 521 cooperative) not subject to the tax on unrelated business income; and any rural electrical and telephone cooperative.

The tax shall be paid by the transferor or, where the transfer is through an agent of the disqualified organization, such agent. The term "agent" includes a broker, nominee, or other middleman. The transferor, or agent as the case may be, will be relieved of liability for this tax if the transferee furnishes an affidavit that it is not a disqualified organization and the person does not have actual knowledge that the affidavit is false.[27]

In addition, the bill provides that the Secretary of the Treasury has the authority to waive the tax in appropriate circumstances where the disqualified organization no longer holds the residual and the transferor (or agent) pays such amount as the Secretary of the Treasury may require. It is expected that such amount will be based on the amount of excess inclusions which accrued with respect to the residual interest while such interest was held by the disqualified organization.

Tax on pass-through entities and nominees

If a disqualified organization is a record holder of an interest in a pass-through entity in any taxable year, a tax is imposed on the pass-through entity equal to the amount of excess inclusions allocable to the disqualified organization for such taxable year multiplied by the highest corporate tax rate. A pass-through entity is any RIC, REIT, common trust fund, partnership, trust, estate, or subchapter T cooperative. Except as provided in Treasury regulations, a person holding an interest in a pass-through entity as a nominee for another person will be treated as a pass-through entity and the holder of the residual interest in the first pass-through entity will be treated as the record holder in the deemed pass-through entity.

Any tax imposed on a pass-through entity by this provision shall be deductible against the gross amount of ordinary income of the entity. Thus, for example, in the case of a REIT, the tax shall be deductible both in determining real estate investment trust taxable income under section 857 and in determining the REIT's ordinary income under section 4981.

It is contemplated that a pass-through entity seeking to assure holders of its interests that it will not incur this tax will adopt measures preventing it from acquiring residual interests. It is also contemplated that a pass-through entity seeking to invest in residual interests without incurring this tax will adopt measures prohibiting ownership of its interests by disqualified organizations (or, where possible, allocating the tax to such entities). The bill provides delayed effective dates to allow certain large pass-through entities time for the adoption of such amendments.

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[27] It is intended that the provision of a social security number under penalties of perjury would satisfy this requirement since disqualified organizations do not have such numbers. In addition, the provision of an employer identification number belonging to an entity other than a disqualified organization might satisfy this requirement.

Signing of return

The bill clarifies that the REMIC has the obligation to file the REMIC return.[28] Although a REMIC is generally treated as a partnership for procedural purposes, the bill provides that the REMIC return would be required to be signed by any person who could sign the return of the entity in the absence of the REMIC election. Thus, the return of a REMIC which is a corporation or trust would be required to be signed by a corporate officer or a trustee, respectively. For REMICs which consist of segregated pools of assets, the return would be required to be signed by any person who could sign the return of the entity which owns the assets of the REMIC under applicable State law.

Other provisions

The bill clarifies that an interest in a REMIC shall be treated as a real estate asset, and that income from the interest shall be treated as interest on an obligation secured by a mortgage on real property, for REIT qualification purposes under section 856. If less than 95 percent of the assets of the REMIC are real estate assets, the REIT is treated as holding directly its proportionate share of the assets of the REMIC and receiving its proportionate share of the income of the REMIC.

The bill clarifies that, where one REMIC owns interests in a second REMIC, the character of the second REMIC's assets flow through for purposes of determining whether interests in the first REMIC constitute qualifying assets to a building and loan association under section 7701(a)(19).

The bill clarifies that the 95-percent test under sections 593(d)(4), 856(c)(6)(E) and 7701(a)(19)(C)(xi) is applied only once with respect to a REMIC which is part of a tiered structure. Thus, for example, if a REIT owns an interest in a REMIC which owns an interest in a second REMIC, the 95-percent test is applied to the REIT's interest in the first REMIC, but not with respect to the REMIC's interest in the second REMIC. Two REMICs are part of a tiered structure if it was contemplated when both REMICs were formed that some or all of the regular interests of one REMIC would be held by the other.

The bill clarifies that certain provisions relating to REMICs are effective as of January 1, 1987. Thus, for example, interests in a REMIC are eligible to be treated as qualifying assets for a thrift institution, regardless of the institution's taxable year. In addition, the bill makes certain clerical and technical amendments to the statute.

Regulatory Authority

The bill also grants authority to the Secretary of the Treasury to provide appropriate rules for the treatment of transfers of qualified replacement mortgages to a REMIC where the transferor holds any interest in the REMIC. It is intended that these regulations may provide rules for determining the basis of mortgages transferred to, or received from, a REMIC as part of a replacement of qualified mortgages, and also may provide rules for determining or adjusting the basis of qualified mortgages held by the REMIC before or after the replacement. In addition, the bill grants authority to the Secretary of the Treasury to provide that a mortgage will be treated as a qualified replacement mortgage only if it is part of a bona fide replacement and is not part of a swap of mortgages. Thus, the Secretary of the Treasury is authorized to issue regulations which prevent a taxpayer from avoiding recognition on the exchange of appreciated mortgages by contributing such mortgages to a REMIC, and then having the REMIC (which will have a fair market value basis in the mortgages), exchange the mortgages for other mortgages.

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[28] It is expected that the Internal Revenue Service will issue employer identification numbers to REMICS.

Effective Dates

In general, the provisions of the bill are effective as of January 1, 1987. The provision relating to the definition of the startup day, the definitions of regular and residual interests, the requirement that qualified mortgages be transferred to the REMIC in exchange for regular or residual interests on the startup day or purchased pursuant to a fixed price contract, and the 100-percent tax on contributions of property to REMICs after the startup day do not apply to any REMIC whose startup day (as defined under present law) is before July 1, 1987. The provision relating to the asset test for REMICs is effective as of January 1, 1988.

The provision requiring REMICs to adopt reasonable arrangements designed to ensure that residual interests in such entities not be held by disqualified organizations is effective for REMICs formed after March 31, 1988, except for REMICs formed pursuant to a binding written contract (i.e., priced) before that date. The tax on transfers of residual interests generally applies to transfers after March 31, 1988. The tax on pass-through entities would generally apply to excess inclusions after March 31, 1988, except for interests in pass-through entities (and residual interests) acquired before that date. The application of the tax on pass-through entities to REITs, RICs, common trust funds and publicly traded partnerships would be effective December 31, 1988. Binding contract exceptions are provided to the transfer and pass-through entity taxes. Unless otherwise elected, the provision relating to the filing of returns is effective for REMICs with a start-up day after the date of enactment of the bill.

VII. MINIMUM TAX PROVISIONS

(Sec. 107 of the bill, sec. 501 of the Reform Act, and secs. 55-59 of the Code)

Present Law

Under present law, as amended by the Act, taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a rate of 21 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. The foreign tax credit generally is allowed to offset up to 90 percent of the tax, and the regular investment tax credit is allowed to offset up to 25 percent of a corporation's minimum tax.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, installment sales, circulation and research and experimental expenditures of individuals, miscellaneous itemized deductions, itemized deductions for State and local taxes, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion in excess of basis, excess intangible drilling costs, incentive stock options, excess bad debt reserves of financial institutions, tax-exempt interest on certain bonds, appreciated property charitable deductions, farm losses, and passive losses.

In addition, for 1987 through 1989, one-half of the excess of pre-tax book income of a corporation over other alternative minimum taxable income is a preference. For taxable years beginning after 1989, three-fourths of the excess of adjusted current earnings over other alternative minimum taxable income is a preference.

These provisions are effective for taxable years beginning after December 31, 1986.

Explanation of Provisions

Computation of tax.—The bill provides that a taxpayer's regular tax will be reduced by the possessions tax credit under section 27(b) since income eligible for the credit is not included in the minimum tax base.

The bill clarifies that a taxpayer subject to the regular tax is also subject to the minimum tax (if the tentative minimum tax exceeds the regular tax), and that where the taxpayer's tax base is measured by something other than taxable income, such as unrelated business taxable income, real estate investment trust taxable income, or life insurance company taxable income, alternative minimum taxable income is determined using that tax base. The bill also clarifies that for nonresident aliens and foreign corporations, the alternative minimum tax applies only to income subject to net basis taxation (secs. 871(b), 877, and 882).

In order to prevent an incentive for separate filing by married persons, the bill provides, in effect, that the maximum amount of the exemption phase-out will be the same as for married taxpayers filing jointly.[1] More specifically, the bill provides that for taxable years ending after the date of enactment of this bill, alternative minimum taxable income of a married person filing a separate return is increased by the lesser of (1) 25 percent of the excess of alternative minimum taxable income (determined without regard to this adjustment) over $155,000 (i.e. the amount at which the exemption phase-out ends on a separate return) or (2) $20,000 (i.e. the maximum exemption amount of the taxpayer's spouse).

Adjustments.—The bill provides that in the case of small construction contracts described in section 460(e)(1), the percentage of the contract completed shall be determined by using the simplified procedures for allocation of costs as added by the bill. The bill also provides that the amount includible in gross income with respect to the alcohol fuels credit (sec. 87) will not be included in alternative minimum taxable income since that credit is not allowed against the minimum tax.

The bill clarifies that the deduction for regular tax purposes for personal exemptions is not allowed under the minimum tax, since a minimum tax exemption amount is provided. Further, the bill provides that only interest which is qualified residence interest for purposes of the regular tax may qualify as deductible housing interest for purposes of the minimum tax[2], clarifies that minimum tax investment interest and minimum tax passive losses do not include minimum tax housing interest, and provides that investment income for purposes of the minimum tax takes into account the minimum tax preferences and adjustments.

Book income.—The bill provides that an income statement that is filed with a Federal, state, or local government must be prepared for a substantial nontax purpose in order to be an applicable financial statement. Thus, an income tax return, franchise tax return or other similar return prepared for the purpose of determining any tax liability that is filed with Federal, State, or local authorities does not constitute an applicable financial statement. In addition, an income statement used by a government for statistical purposes only is not prepared for a substantial nontax purpose. The bill also provides that if a taxpayer has two or more financial statements with the same priority, the applicable financial statement shall be the one specified in regulations promulgated by the Secretary of the Treasury.

The gross amount of dividends (i.e. gross of any withholding taxes) received from a section 936 corporation, like dividends received from other nonconsolidated corporations, are included in the recipient's adjusted net book income. To the extent that the alternative minimum taxable income of the recipient is increased by reason of the inclusion of such dividends in adjusted net book income, the bill clarifies that a pro rata portion of withholding or income taxes is treated, for minimum tax purposes, as creditable foreign taxes paid by the recipient. The maximum amount of withholding or income taxes that may be treated as creditable foreign taxes is 50 percent of the taxes. However, this amount is reduced on a proportionate basis if a lesser amount of the dividends from the 936 corporation is taken into account in computing alternative minimum taxable income.

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[1] Similarly, the benefit of the 15-percent bracket for married individuals filing a separate return is phased out under the regular tax as if a joint return were filed.

[2] Section 204(a) of the bill also makes several minor conforming amendments to the definition of qualified housing interest to conform to the changes made by the Revenue Act of 1987 to the definition of qualified residence interest under the regular tax.

The bill also clarifies that if a taxpayer does not choose to take the benefit of section 901 with respect to income, war profits, or excess profits taxes imposed by a foreign country or possession of the United States, or is prohibited from taking the benefit of section 901 (i.e. taxes described in section 901(j)), adjusted net book income is reduced by only those taxes. That is, taxes which are not deductible for regular tax purposes (for example, withholding or income taxes imposed by a U.S. possession on dividends received from a section 936 corporation) are not deductible for this purpose. Similarly, the related income is to be reflected gross of any of these nondeductible taxes.

Adjusted current earnings.—The bill clarifies that the rule providing that income on an annuity contract is included in adjusted current earnings does not apply to a qualified annuity contract held under a plan described in section 403(a).

The bill provides an elective alternative to the general rule requiring depreciation for adjusted current income purposes to be computed using whichever of two methods yields deductions with the smallest present value. The two methods are the alternative depreciation system described in section 168(g) and the method used for book purposes. Instead, a taxpayer may elect to compute depreciation for adjusted current earnings purposes by taking a deduction equal to the amount necessary to increase the amount of accumulated depreciation (for adjusted current earnings purposes) on the property to the lesser of the accumulated depreciation allowed as of the end of the taxable year under either the alternative depreciation system described in section 168(g) or the the method used for book purposes. The election does not affect the depreciable basis allowed for purposes of the adjusted current earnings provision.

A taxpayer may elect to use the alternative method for any taxable year beginning after 1989. The election applies to all property placed in service during that taxable year, and is irrevocable with respect to such property. If an election is made for the first taxable year for which the adjusted current earnings provision is effective, the election applies to all property placed in service during that taxable year and all previous taxable years. A taxpayer is not required to use the alternative method for property placed in service during any subsequent taxable year by reason of having made the election for a prior taxable year.

The bill also provides a special rule in the case of any property subject to a lease where the income of the taxpayer for book purposes with respect to such property is determined without regard to an allowance for depreciation. This situation may arise, for example, where a taxpayer leases property in a transaction that is treated for book purposes as a direct financing lease under FAS 13 (as amended).

In such a situation, the excess (if any) of the income from the lease for adjusted current earnings purposes (determined without regard to this provision or any other allowance for depreciation) over the income from the lease reported for book purposes is treated as the depreciation deduction determined with respect to such property for book purposes.

The adjusted current earnings depreciation for such property for any taxable year is to be determined using the special rule described above. This use of the special rule is not intended to be considered as an election of the alternative method applicable to all property placed in service during the taxable year.

The bill additionally provides that, in the case of property described in paragraphs (1), (2), (3), or (4) of section 168(f), the amount of depreciation allowable for regular tax purposes shall be treated as the amount allowable under the alternative system of section 168(g) for the purpose of determining adjusted current earnings depreciation. It is normally anticipated that the alternative method (described above) will be used and that such use will not be considered as an election of the alternative method applicable to all property placed in service during that taxable year.

Preferences.—The bill clarifies that the preference for bond interest only applies to tax-exempt bonds and the exception for refunding bonds includes both current and advance refundings. The bill also clarifies that the charitable contribution preference applies to trusts and estates as well as all other taxpayers.

The bill provides that for purposes of the individual minimum tax, stock acquired pursuant to the exercise of an incentive stock option exercised after October 16, 1987, will be treated without regard to the rules of section 421. Instead the rules of section 83 will apply to the stock in determining the individual's alternative minimum taxable income. For example, if a taxpayer acquires stock pursuant to the exercise of an incentive stock option and disposes of the stock in the same taxable year, the tax treatment under the regular tax and the minimum tax will be the same; if the stock is disposed of in a disqualifying disposition in a subsequent taxable year, the "spread" between the option price and fair market value of the stock (determined in accordance with the rules of section 83) will be included in alternative minimum taxable income in the first taxable year and in taxable income (but not in alternative minimum taxable income) in the subsequent taxable year. In addition, if the stock acquired is subject to a lapse restriction, amounts will be included in the alternative minimum taxable income in accordance with the rules of section 83. (For options exercised on or before October 16, 1987, and disposed of in a disqualifying disposition, the minimum tax treatment and the regular tax treatment will be the same for both the year of exercise and the year of disposition.)

Investment tax credits.—The bill clarifies that the total amount of the general business credit allowable to a C corporation for a taxable year in which the regular tax exceeds the tentative minimum tax is determined as if the portion of the general business credit not attributable to the regular investment tax credit first offset the regular tax, and the regular investment credits (to the extent otherwise available) then reduced the net tax to 75 percent of the tentative minimum tax. This rule affects only the determination of amount of the general business credit allowable in a taxable year and does not change the usual ordering rules of section 38.

For example, assume a corporation had $100 million of regular tax, $80 million of tentative minimum tax, $30 million of regular investment tax credits (disregarding the cutback under section 49 for purposes of this example), and $20 million of other general business credits. $40 million of the general business credit would be allowed for the taxable year—$20 million by reason of the general rule of section 38(c)(1) allowing the general business credit to offset the excess of the net income tax over the tentative minimum tax and $20 million by reason of the special rule of section 38(c)(2) (as redesignated by the bill) allowing unused regular investment credits to offset 25 percent of the tentative minimum tax. The above result would occur without regard to the taxable years in which the various credits arose.

The bill also clarifies that the regular investment tax credit cannot be used in a taxable year to the extent that it, in conjunction with the NOL deduction and the foreign tax credit, would reduce the amount of tax payable by the taxpayer to less than 10 percent of the tentative minimum tax (determined without regard to the NOL deduction and foreign tax credits).

Foreign tax credits.—The bill clarifies that for purposes of determining whether any income is high-taxed income in applying section 904(d)(2) in computing the alternative minimum tax foreign tax credit, the alternative minimum tax rate is to be used in lieu of the regular tax rate. The bill also clarifies that foreign taxes paid or accrued in a taxable year beginning after December 31, 1986, which are carried back to offset tax in a taxable year beginning before January 1, 1987, may not be used in computing the alternative minimum tax foreign tax credit for years beginning after 1986.

Clerical amendments.—The bill makes numerous clerical amendments and corrects several cross references to these provisions.

Transitional provisions.—The bill provides that, for property that is depreciated under the new ACRS system during a taxable year of the taxpayer that begins before 1987, the new minimum tax depreciation (or pollution control facility amortization) rules apply to measure the preference, but the preference applies only to property to which the prior law rules of paragraphs (4) and (12) of section 57(a) applied. The bill also provides that in the case of a fiscal year trust or estate beginning in 1986 and ending in 1987, the prior law apportionment rules will apply notwithstanding that a beneficiary's taxable year begins in 1987. The bill also contains certain transition rules that were inadvertently amended or deleted in enrolling the Act.

VIII. ACCOUNTING PROVISIONS (SEC. 108 OF THE BILL)

1. Limitation on the use of the cash method of accounting (sec. 108(a) of the bill, sec. 801 of the Reform Act, and secs. 448, 461, and 464 of the Code)

a. Definition of qualified personal service corporations

Present Law

Qualified personal service corporations are excepted from the general rule denying the use of the cash method of accounting to a C corporation or a partnership with a C corporation as a partner. A qualified personal service corporation is a corporation that meets both a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field or fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

The ownership test is met if substantially all (i.e., 95 percent) of the value of the outstanding stock in the corporation is owned, directly or indirectly, by employees performing services for the corporation in connection with the qualified services performed by the corporation, retired individuals who performed such services for the corporation or its predecessor(s), the estate of such an individual, or any other person who acquired stock by reason of the death of such an employee (for the two-year period beginning with the death of such employee).

A special rule is provided allowing the common parent of an affiliated group (within the meaning of sec. 1504(a)) to elect to treat all members of such affiliated group as one taxpayer for the purpose of determining if the ownership test is met, provided that substantially all of the activities of the members of such affiliated group involve the performance of services in the same field satisfying the function test.

Explanation of Provision

The bill provides that, for the purpose of determining if a corporation meets the ownership test, indirect ownership of stock is to be taken into account only where stock is owned indirectly through one or more partnerships, S corporations, or qualified personal service corporations. Thus, other forms of indirect stock ownership (e.g., as a result of attribution between family members) are not considered in determining if the ownership test is satisfied. Stock that is owned by a partnership, S corporation, or qualified personal service corporation is considered to be owned by its owners in the same proportion as their ownership of the partnership, S corporation, or qualified personal service corporation. The Secretary of the

Treasury is directed to prescribe those regulations that may be necesary to prevent the use of related parties, pass-through entities, or intermediaries to avoid the application of the rules denying the use of the cash method of accounting.

The bill also provides that a common parent of an affiliated group may elect to treat all members of such group as one taxpayer for the purpose of determining if the ownership test is met where 90 percent or more of the activities of such affiliated group involve the performance of services in the same field satisfying the function test. Thus, if 90 percent or more of the activities of the affiliated group, taken as a whole, are the performance of services in a field satisfying the function test, an election is available to apply the ownership test to the group as a whole. The function test, however, must still be applied to each separate corporation.

b. Treatment of tax shelters

Present Law

Section 448(a)(3) provides that the cash method of accounting may not be used by any tax shelter. For this purpose, a tax shelter is defined as (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate within the meaning of section 1256(e)(3)(B); or (3) any tax shelter within the meaning of section 6661(b)(2)(C)(ii). Treasury regulations promulgated under section 448 provide that an offering is required to be registered with a Federal or State agency if, under the applicable Federal or State law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or State law (regardless of whether the notice is in fact filed).

Under section 461(i), in the case of tax shelters, no deduction is allowed with respect to an item until there has been economic performance with respect to that item. Under a special rule applicable to tax shelters in oil and gas, economic performance with respect to drilling of an oil or gas well is deemed to occur at the time of spudding.

Explanation of Provision

When the special spudding rule for economic performance was adopted by Congress in the Deficit Reduction Act of 1984, economic performance was deemed to occur at the time of spudding of an oil or gas well where the taxpayer had paid for the drilling costs prior to the close of the taxpayer's year. The Reform Act inadvertently removed the requirement that the taxpayer must have paid for the drilling costs by the close of the taxpayer's year in order for the special spudding rule to apply. The bill provides that tax shelters in oil and gas must have paid for the drilling activity before the end of its taxable year in order for spudding to be considered as economic performance.

In the case of a partnership, a partner's deduction of drilling expenses that are treated as economically performed by reason of the spudding rule is limited to the partner's cash basis in the partnership. A partner's cash basis is equal to the adjusted basis of it's interest in the partnership, determined without regard to amounts related to certain borrowings. These amounts are (1) any liability of the partnership, (2) any amount borrowed by the partner with respect to the partnership which was either arranged by the partnership or any participant in the organization, sale or management of the partnership, and (3) any amount borrowed by the partner if such borrowing was secured by any assets of the partnership.

The bill also clarifies the definition of tax shelter for purposes of the denial of the cash method of accounting. Under the bill, an S corporation is not treated as a tax shelter for this purpose merely by reason of the filing of a notice of exemption from registration with a State agency that has the authority to regulate the offering of securities for sale. It is anticipated that an S corporation that is prohibited from using the cash method of accounting under present law solely by reason of having filed such a notice of exemption and, consequently, has changed to a method of accounting other than the cash method for its first taxable year beginning after 1986, will be allowed, under this technical amendment, to retain its prior method of accounting.

c. Limitations on farming deductions

Present Law

The Reform Act denies the use of the cash method of accounting to any tax shelter. The definition of tax shelter for this purpose includes all farming syndicates. Thus, under the Reform Act, farming syndicates are generally required to capitalize the cost of feed, seed, fertilizer, and other similar farm supplies and deduct these costs when the crop or animal to which the costs relate is sold or otherwise disposed of.

Under section 464(a), farming syndicates are allowed a deduction for amounts paid for feed, seed, fertilizer, or other similar farm supplies no earlier than the taxable year in which such feed, seed, fertilizer, or other supplies actually are used or consumed.

Under section 464(b), farming syndicates are required to capitalize the cost of poultry purchased for use in a trade or business and to deduct such cost ratably over the lesser of 12 months or the useful life of such poultry in the trade or business. In addition, a farming syndicate may deduct only the cost of poultry purchased for sale in the taxable year in which the poultry is disposed of.

The Reform Act applies section 464(a) and 464(b) to certain persons prepaying 50 percent or more of certain farming expenses, with respect to the portion of such expenses exceeding 50 percent.

Explanation of Provision

The bill provides that sections 464(a) and 464(b) shall not apply to farming syndicates in taxable years beginning after December 31, 1986, because these rules are rendered unnecessary by the rules of the Reform Act that require tax shelters to use an accrual method of accounting. The bill also provides for the issuance of regulations by the Secretary of the Treasury is to issue regulations that insure that the use of the unit livestock method by accrual basis taxpayers will accurately reflect income.

2. Capitalization rules for inventory, construction, and development costs (sec. 108(b) of the bill, sec. 803 of the Reform Act, and sec. 263A of the Code)

Present Law

In general

The uniform cost capitalization rules apply to the manufacture or construction of all tangible property and to the purchasing and holding property for resale. Exceptions to these rules are provided for property produced by the taxpayer for personal use, research and experimental costs allowable as a deduction under section 174, certain development and other costs of oil and gas wells and mineral property deductible under section 263(c), 616(a), or 617(a), property produced pursuant to a long-term contract, and the production of timber and certain ornamental trees.

Simplified method for taxpayers acquiring property for resale

Taxpayers with gross receipts in excess of $10 million who acquire personal property for resale and all taxpayers who acquire real property for resale are required to apply the uniform capitalization rules with respect to such property. The uniform capitalization rules require that all direct costs of such property and such property's proper share of those indirect costs, part or all of which are allocable to such property, be absorbed into the inventory costs of the property, rather than currently expensed. Included in the costs required to be absorbed into inventory cost are off-site storage costs and related handling costs. The Secretary of the Treasury is directed to prescribe regulations providing for simplified procedures for the application of the uniform capitalization rules in the case of property acquired for resale.

Capitalization of interest

Interest costs are subject to special rules. Capitalization of interest is required only if the taxpayer is engaged in the manufacture or construction of property (i.e., resellers are exempt), and only if the property produced is real property or personal property that is long-lived or has an extended production period. Interest costs are allocable to the production or construction of property if they are directly attributable to production expenditures incurred in producing the property, or could have been avoided if the production expenditures had not been incurred. Interest incurred or continued in connection with property used to produce property is also subject to capitalization.

Special rules for farmers

Special rules also apply to the production of farm products. In general, the uniform capitalization rules apply to such production only if the product has a preproductive period of more than two years. This exception for property with a preproductive period of less than two years does not apply to taxpayers required to use an accrual method of accounting under section 447 or 448. Except for taxpayers using an annual accrual method of accounting, taxpayers required to use an accrual method of accounting must capitalize preproductive expenses. The costs required to be capitalized with respect to farming animals may be determined using the unit livestock method.[1]

Certain farmers otherwise required to capitalize preproductive period costs may elect to deduct such costs currently, provided the alternative cost recovery system is used on all farm assets and the expensed costs are recaptured upon disposition of the product. The election is not available to taxpayers required to use the accrual method of accounting or engaged in the production of pistachios. Moreover, the election is not available with respect to certain costs attributable to citrus or almond groves.

Costs incurred in replanting edible crops following loss or damage due to freezing temperatures, disease, drought, pests, or casualty may be deducted currently. This exception may apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred and (2) the person claiming the deduction materially participates in the planting or maintenance of the property during the four-taxable year period beginning with the year of the loss or damage.

Effective dates

In the case of inventories, the provisions generally are effective for taxable years beginning after December 31, 1986. In the case of self-constructed property, the rules apply to costs incurred after December 31, 1986, unless incurred with respect to property on which substantial construction (whether by the taxpayer or by another person) occurred before March 1, 1986. In the case of noninventory property held for sale, the rules apply to costs incurred after December 31, 1986.

Explanation of Provision

In general

The bill adds to the list of costs specifically exempted from the uniform capitalization rules costs incurred in connection with oil and gas wells or mineral property that are subject to amortization pursuant to section 291(b)(2), 263(c), 263(i), 616, or 617, and costs (other than circulation expenditures) subject to ten-year amortization under section 59(e).

Simplified method for taxpayers acquiring property for resale

The Secretary of the Treasury is directed to issue regulations providing for simplified procedures for the application of the uniform capitalization rules in the case of property acquired for resale.

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[1] The Internal Revenue Service has announced that the annual standard price used in determining unit costs under the unit livestock method is to be modified to reflect the particular period in the taxable year in which the purchases of livestock are made in order to avoid distortions of income that would otherwise occur through operation of the unit livestock method. Notice 88-24, 1988-14 I.R.B. —.

It is anticipated that such regulations will provide a method for computing allocation ratios for the purpose of assigning a portion of total costs to ending inventory or cost of sales. The allocation ratio for assigning storage costs and related handling costs is to be determined by dividing the gross amount of such costs by the sum of beginning inventory balances plus purchases for the taxable year.

Capitalization of interest

The bill also clarifies that, in determining the amount of interest that must be capitalized in connection with an asset used to produce property, the methods applied under the general interest allocation rules are applied to the full cost of the asset.[2] Accordingly, any interest specifically traceable to such an asset must first be allocated to the produced property; interest on other debt of the taxpayer is then allocated to the extent required under the avoided cost method.[3]

Finally, the bill clarifies that a cost is subject to capitalization under this provision only to the extent it is otherwise taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer's interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner.

Special rules for farmers

The special rule for costs incurred by persons other than the taxpayer in connection with replanting a crop of the taxpayer following loss or damage due to freezing temperatures, etc., is modified. Under the bill, such costs may be deducted without regard to whether they were incurred (or the persons' material participation occurs) within the four-taxable year period following the loss or damage.

Many taxpayers using the annual accrual method of accounting, other than taxpayer's engaged in the trade or business of growing sugar cane, were required under section 278 of prior law to capitalize preproductive expenses (e.g., citrus growers). The Reform Act repealed section 278. Under the bill, the special rule that allows taxpayers using the annual accrual method of accounting to expense preproductive expenses is limited to those taxpayers engaged in the trade or business of farming sugar cane.

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[2] If an asset is not used exclusively in the production of a single property, the total interest cost associated with the asset is allocated among the various properties produced.

[3] To avoid double counting, any interest allocated to property under this rule is not again allocated to the property under the general interest allocation rule. For example, interest allocated under the general rule to depreciation on an asset used to produce property, which would be a production expenditure that would "attract" interest under the avoided cost method, might otherwise duplicate interest allocated under this special rule for production-related assets.

3. Long-term contracts (sec. 108(c) of the bill, sec. 804 of the Reform Act, and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs.[4]

In the taxable year in which a contract reported under the percentage of completion method is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if gross income had been computed by using the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment.

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 70 percent of the items with respect to the contract under the percentage of completion method. The remaining 30 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., completed contract method, accrual shipment method).[5]

Costs that directly benefit, or are incurred by reason of, a taxpayer's long-term contract activities must be allocated to its long-term contracts in the manner provided in the Treasury regulations under section 451 for extended period long-term contracts. This method of allocation is required irrespective of whether the contract is reported under the percentage of completion-capitalized cost method or the percentage of completion method. While costs may be deducted in the year incurred if they relate to a contract (or portion of a contract) reported under the percentage of completion method, whether costs are allocable to such a contract is nonetheless relevant because it affects the determination of the percentage of the contract completed during the year.

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[4] This calculation is done on a cumulative basis. Thus, the amount included in gross income for a particular taxable year is that proportion of the expected contract price that the amount of costs incurred through the end of the year bears to total expected costs, reduced by the amount of gross contract price included in gross income for previous taxable years.

[5] For contracts entered into after February 28, 1986, and before October 14, 1987, 40 percent of the items with respect to a contract must be taken into account under the percentage of completion method and the remaining 60 percent of the items must be taken into account under the taxpayer's normal method of accounting.

Explanation of Provision

The bill authorizes the Secretary of the Treasury to prescribe a simplified procedure for the allocation of costs to a contract for purposes of applying the percentage of completion method. Thus, for example, the Secretary may permit the determination of the percentage of a contract completed during the taxable year to be based on fewer costs than are taken into account for purposes of applying the completed contract method or other long-term contract method of accounting. This simplified method may not be used by taxpayers using the percentage of completion-capitalized method for accounting for long-term contracts.

The bill also provides that, in applying the look-back method, amounts received or accrued after completion of the contract are taken into account by discounting such amounts to their value as of the completion of the contract. The Federal mid-term rate as of the time the amount was received is the applicable discount rate. The bill exempts a long-term contract from application of the look-back method if the taxpayer expects to complete the contract within two years of the contract commencement date and the gross contract price does not exceed the lesser of $1 million or 1 percent of the taxpayer's average gross receipts for the three taxable years preceding the year the contract was entered into.

4. Taxable years of certain entities (sec. 108(e) of the bill, sec. 806 of the Reform Act, and secs. 706, 1378, 441, and 267 of the Code)

a. Majority interest taxable years

Present Law

A partnership may not have a taxable year other than the taxable year of the partners owning a majority interest in partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as its principal partners. If the principal partners of the partnership do not have the same taxable year and no majority of its partners have the same taxable year, the partnership must adopt the calendar year or such other period as the Secretary of the Treasury may prescribe by regulations.

The majority interest rule does not apply unless the period that constitutes the taxable year of partners owning a majority interest in partnership profits and capital has been the same for the three-taxable-year period of such partners ending on or before the beginning of such taxable year of the partnership. If the partnership has not been in existence for all of such three-taxable-year period, the period that constitutes the taxable year of the partners owning a majority interest in profits and capital must have been the same for the taxable years of such partners ending with or within the period of the partnership's existence.

Explanation of Provision

The bill provides that a partnership may not have a taxable year other than its majority interest taxable year. If the partnership does not have a majority interest taxable year, it may not have a taxable year other than the taxable year of all of its principal partners. If the partnership does not have a majority interest taxable year and all of its principal partners do not have the same taxable year (or the partnership has no principal partners), the partnership may not have a taxable year other than the calendar year, unless the Secretary of the Treasury, by regulations, prescribes another period.

The majority interest taxable year is the taxable year (if any) that, on the testing day, constituted the taxable year of one or more partners having (on the testing day) an aggregate interest in partnership profits and capital of more than 50 percent. Generally, the testing day is the first day of the partnership's taxable year. The Secretary of the Treasury may provide that an alternate, representative period be used as the testing day, rather than the first day of the taxable year, if such period is more representative of the ownership of the partnership. A partnership that is required to change its taxable year to its majority interest taxable year is not required to change to another taxable year for either of the two taxable years following the year of change.

b. Sequence of required changes in taxable years

Present Law

The requirement of the Reform Act that partnerships conform their taxable years to the taxable years of their owners does not take into consideration changes in taxable years of such owners that also may be required by the Act. Thus, such partnerships may be required to change their taxable years several times as the taxable years of their owners change.

Explanation of Provision

The bill provides that, except as otherwise provided in regulations issued by the Treasury Secretary, the changes in taxable years of other persons required to change taxable years are to be taken into account in determining the required taxable year of a partnership.

c. Personal service corporations

Present Law

A personal service corporation is required by the Reform Act to adopt a calendar year, unless it establishes to the satisfaction of the Secretary of the Treasury a business purpose for a different taxable year. A personal service corporation is a corporation the principal activity of which is the performance of personal services if services are substantially performed by employee-owners.

Explanation of Provision

The bill provides that a corporation is not considered to be a personal service corporation for this purpose unless more than 10 percent of the stock (by value) in such corporation is held by employee-owners.

The bill further provides that, if a corporation is a member of an affiliated group filing a consolidated return, all members of such group shall be taken into account in determining whether such corporation is a personal service corporation.

d. Common trust funds

Present Law

The Reform Act did not address the taxable year to be used by a common trust fund taxed under section 584.

Explanation of Provision

Consistent with the rules requiring use of a calendar year for other pass-through entities (e.g., partnerships, S corporations, trusts), the bill requires the taxable year of a common trust fund to be the calendar year. If a common trust fund is required to change taxable years as a result of this provision, and as a result of such change a participant in such common trust fund is required to include items from more than one taxable year of the common trust fund in any of the participant's taxable years, the items from the short taxable year of the common trust fund may be included in income by the participant ratably over a four-taxable-year period, unless the participant elects to include all such items currently.

e. Effective date

Present Law

The Reform Act provides that, if any partner or shareholder of an S corporation is required to include the items from more than one taxable year of the partnership or S corporation in any one taxable year, income in excess of expenses for the short taxable year of the partnership or S corporation is to be taken into account ratably in each of the first four taxable years (including such short taxable year) beginning after December 31, 1986, unless the partner or shareholder of the S corporation elects to include all such income in the short taxable year.

The Internal Revenue Service has issued a revenue procedure which sets forth rules under which the Service will permit electing S corporations to adopt taxable years other than a calendar year. Rev. Proc. 83-25, 1983-1 C.B. 689. Under the so-called "25-percent test" of that revenue procedure, an electing S corporation generally may adopt, retain, or change to a taxable year if, among other tests, 25 percent or more of the gross income of the taxpayer is realized in the last two months of that year.

Explanation of Provision

The bill clarifies that the four year spread provided by the Reform Act for partners and shareholders in S corporations is only applicable to changes in taxable years that are required by the Reform Act for the first taxable year beginning after December 31, 1986. The bill clarifies that the four year spread is made at the partner or shareholder level, rather than at the level of the partnership or S corporation.

The adjusted basis of a partner in a partnership interest or of an S Corporation shareholder in stock is determined as if all of the income to be taken into account over the four year spread period were included in gross income in the first taxable year. Thus, current distribution of an amount equal to the amount of income attributable to the partner or S corporation shareholder in the short taxable year will not result in capital gain, unless the distribution would have had such an effect had there been no four year spread. If any interest in a partnership or stock in an S corporation is disposed of before the last taxable year in the spread period, any income attributable to the interest or stock disposed of that remains to be recognized pursuant to the spread is included in the gross income in the same taxable year as the interest or stock is disposed of.

The bill provides that the four year spread for income attributable to a short taxable year will apply only once in the case of a passthrough or tiered item.

The bill provides that the Internal Revenue Service is not required to permit taxpayers to have an automatic change of a taxable year. Thus, taxpayers meeting the "25-percent test" of Rev. Proc. 83-25 are not automatically permitted to adopt or change to a year allowed under that revenue procedure.

5. Treatment of installment obligations (sec. 108(f) of the bill, sec. 811 of the Reform Act, and secs. 453 and 453C of the Code)

Present Law

In applying the proportionate disallowance rule,[5] the installment percentage of a taxpayer's average quarterly indebtedness generally is treated as a payment on the taxpayer's applicable installment obligations. The taxpayer's year-end indebtedness may be used instead of average quarterly indebtedness if the taxpayer has no applicable installment obligations arising from dealer sales outstanding at any time during the taxable year. In addition, in applying the proportionate disallowance rule, all assets and indebtedness of certain related taxpayers are aggregated.

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[5] The Revenue Act of 1987 repealed the installment method for dealer dispositions occurring after December 31, 1987. An applicable installment obligation arising out of a dealer disposition occurring after February 28, 1986, and before January 1, 1988, is subject to the proportionate disallowance rule for taxable years ending after December 31, 1986, and beginning before January 1, 1988.

In addition, the 1987 Act repealed the proportionate disallowance rule for nondealer real property installment obligations arising out of dispositions occurring in taxable years beginning after December 31, 1987. Nondealer real property installment obligations arising out of dispositions occurring after August 16, 1986, in taxable years beginning before January 1, 1988, are subject to the proportionate disallowance rule in any later taxable year for which a taxpayer has allocable installment indebtedness. A taxpayer may elect early application of the interest and pledge rules contained in the 1987 Act, in which case the proportionate disallowance rule does not apply to nondealer real property installment obligations.

Applicable installment obligations include installment obligations arising from certain specified types of sales, which installment obligations are held by the seller or a member of the same affiliated group (within the meaning of sec. 1504(a) without regard to sec. 1504(b)) as the seller. Obligations arising from sales of personal property pursuant to a revolving credit plan or obligations arising from the sale of publicly traded property may be treated as applicable installment obligations. Personal use property and indebtedness secured primarily by such property are not taken into account for purposes of applying the proportionate disallowance rule of section 453C to applicable installment obligations arising from dealer sales.

Taxpayers who are required to change their method of accounting for sales pursuant to a revolving credit plan because of section 812 of the Reform Act must take into income any adjustment arising under section 481 over a period of four years, with specified percentages for each of the four years.

Explanation of Provisions

The bill provides that taxpayers who have no applicable installment obligations outstanding at year-end other than applicable installment obligations arising from non-dealer sales, must use their year-end indebtedness, rather than their average quarterly indebtedness for purposes of applying the proportionate disallowance rule. The bill provides that personal use property and indebtedness secured primarily by such property are not taken into account for purposes of applying the proportionate disallowance rule of section 453C to applicable installment obligations arising from non-dealer sales. The bill also grants authority to the Treasury Department to issue regulations modifying the rules requiring aggregation of the assets and indebtedness of certain related taxpayers.

The bill clarifies that the term "applicable installment obligation" includes installment obligations arising from certain specified types of sales, which installment obligations are held by the seller or any person if the basis of such obligation in the hands of such person is determined (in whole or in part) by reference to the basis of such obligation in the hands of another person and such obligation was an applicable installment obligation in the hands of such other person. Thus, for example, if an applicable installment obligation is transferred to a partnership or a trust in a nonrecognition transaction and the partnership or trust has a carryover basis in the installment obligation, then the obligation is treated as an applicable installment obligation in the hands of the partnership or trust.

The bill also clarifies that installment obligations arising from the sale of personal property pursuant to a revolving credit plan or from the sale of publicly traded property are not treated as applicable installment obligations. Thus, such installment obligations are not subject to the proportionate disallowance rule. In addition, the bill clarifies that the provision denying the use of the installment method for sales of publicly traded property applies with respect to sales of such property after December 31, 1986.

In addition, the bill clarifies how the proportionate disallowance rule is applied with respect to applicable installment obligations arising after February 28, 1986, but in a taxable year prior to the first taxable year ending after December 31, 1986. The bill specifies that any such applicable installment obligations are treated as arising on the first day of the first taxable year of the taxpayer ending after December 31, 1986.

The bill provides that if a taxpayer's last taxable year beginning before January 1, 1987, was the taxpayer's first taxable year in which sales were made under a revolving credit plan, then all adjustments under section 481 are taken into account in the taxpayer's first taxable year beginning after December 31, 1986. The bill also provides that the adjustment under section 481 required by the repeal of the installment method for revolving credit plans is to be taken into account no slower than the rate of contraction of the taxpayer's revolving credit installment obligations. For this purpose, the rate of contraction equals a fraction the numerator of which is the amount by which (1) the aggregate face amount of revolving credit obligations outstanding as of the close of the last taxable year beginning before January 1, 1987, exceeds (2) the aggregate face amount of revolving credit obligations outstanding as of the taxable year under consideration and the denominator of which is the aggregate face amount of revolving credit obligations outstanding as of the close of the last taxable year beginning before January 1, 1987.

The bill also provides that if a taxpayer sells any receivables that arose pursuant to a revolving credit plan and that were taken into account in computing the adjustment under section 481 relating to the change from the installment method to the accrual method, then the taxpayer may not recognize any loss on the sale of such receivables. If a loss is realized on any such sale, however, then the taxpayer may reduce the aggregate amount of the adjustment under section 481 for the fourth taxable year beginning after December 31, 1986, by the amount of such loss; to the extent that the loss exceeds the aggregate adjustment for such fourth taxable year, then the adjustment for the third taxable year is reduced, and so on.

Further, the bill corrects certain clerical and technical errors.

6. Income attributable to utility services (sec. 108(i) of the bill, sec. 822 of the Reform Act, and sec. 451 of the Code)

Present Law

Accrual basis taxpayers are required to recognize income attributable to the furnishing or sale of utility services to customers not later than the taxable year in which such services are provided to the customer. For taxable years beginning after December 31, 1986, the year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time that the customer is billed (or may be billed) for such services.

For any taxable year beginning before August 16, 1986, a method of accounting that took into account income from the furnishing or sale of utility services on the basis of the period in which the customer's meters were read is deemed to be proper for Federal income tax purposes.

Explanation of Provision

The bill provides that, for taxable years beginning on or after August 16, 1986, and before January 1, 1987, a method of accounting that took into account income from the furnishing or sale of utility services on the basis of the period in which the customer's meters were read is deemed to be proper for Federal income tax purposes, provided such income was treated in the same manner for the taxable year preceding any such taxable year. No inference is intended as to whether or not such method is proper if the method was not actually used by the taxpayer for the preceeding taxable year.

In providing that a method of accounting which takes into account income from the providing of utility services on the basis of the period in which the customers' meters are read will be deemed proper for Federal income tax purposes for any period, no inference of propriety was intended for any method that did not strictly adhere to the meter reading method for all customers of the utility. In addition, no inference was intended with regard to other questions of law, including but not limited to the treatment of prepaid income amounts for the provision of utility services at a future date, the treatment of deposits made by utility customers, or the treatment of amounts received or accrued by the utility under a "budget-billing" procedure.

IX. FINANCIAL INSTITUTIONS (SEC. 109 OF THE BILL)

1. Limitations on bad debt reserves (sec. 109(a) of the bill, sec. 901 of the Reform Act, and sec. 46(e)(4) of the Code)

Present Law

Thrift institutions

Section 901 of the Reform Act reduced the portion of taxable income that thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) may deduct as an addition to reserves for bad debts from a maximum of 40 percent to eight percent. In addition, an institution otherwise meeting the definition of a thrift institution is required to hold at least 60 percent of its assets in qualifying assets in order to meet the definition of a thrift institution.

Prior and present law limits the amount of investment eligible for the investment tax credit in the case of a thrift institution to 50 percent of the amount otherwise allowable. Where a thrift institution is the lessee of property that is eligible for the investment tax credit, the lessor is treated as a thrift institution with respect to such property, unless the thrift institution has elected to compute its deduction for bad debts using the experience method. Such an election is binding on the thrift institution for all subsequent years.

Commercial banks

Section 901 of the Reform Act also repealed the use of the reserve method in computing the deduction for bad debts of "large banks." A bank is considered to be a "large bank" if, for the current taxable year or any taxable year beginning after December 31, 1986, the sum of the average adjusted bases of all assets of such bank (or any controlled group of which the bank is a member) exceeds $500 million.

A large bank that has previously used the reserve method in computing its deduction for bad debts generally is required to include in income the balance of any reserve for bad debts over a period of four taxable years, beginning with the disqualification year. Ten percent of the reserve balance is included in income in the disqualification year, 20 percent in the first taxable year following the disqualification year, 30 percent in the second following year, and 40 percent in the third taxable year following the disqualification year. An election may be made to include more than 10 percent of the reserve in the disqualification year, in which case 2/9ths of the remainder of the reserve balance is included in income in the first taxable year following the disqualification year, 1/3rd of the remainder in the second following year, and 4/9ths of the remainder of the reserve in the third year following the disqualification year.

A bank, that is recapturing its existing bad debt reserve by including an amount in taxable income, must, except for the election described below, suspend the inclusion in income of its bad debt reserve for any year in which it is a "financially troubled bank." In the case of a bank that is a member of a controlled group described in section 1563(a)(1), the determination of whether the bank is a financially troubled bank is made with respect to all members of that controlled group. If a bank is troubled in its first disqualification year, an election may be made to recognize in income all or a portion of the amount of its reserves that otherwise would be recaptured in such year.

In lieu of the recapture of a bad debt reserve by its inclusion in income, an election may be made to use the cut-off method. A bank using the cut-off method is required to segregate its outstanding loans into two accounts. One account consists of loans created on or after the first day of the disqualification year. The specific charge-off method is required to be used in computing the deduction for bad debts attributable to the loans in this account. The second account consists of loans that were outstanding on the last day of the taxable year before the disqualification year. The deduction for bad debts attributable to the loans in this account continues to be determined using the reserve method. However, no deductions are allowed for additions to this reserve. The rules providing for the suspension of recapture of the bad debt reserve by a bank that is a financially troubled bank are inapplicable if the cut-off method is elected.

Explanation of Provision

Thrift institutions

The bill provides that an election by a lessee thrift institution to use the experience method of computing its deduction for bad debts shall terminate effective with respect to the first taxable year of the electing organization beginning after 1986 and during which such organization (or any successor organization) was not the lessee under any lease of regular investment tax credit property. Regular investment tax credit property is any section 38 property if the regular percentage applied to such property and the amount of qualified investment with respect to such property would have been reduced but for the election by the organization.

The effect of the provision is to allow a thrift institution that had committed to the use of the experience method of accounting for bad debts in order to avoid certain reductions in investment tax credit to use the percentage of income method in taxable years beginning after 1986, provided the thrift institution is not a lessee of property that was eligible for investment tax credit without reduction as a result of the prior election.

Commercial banks

In the case of a "large bank", the bill provides that an election made by a member of a parent-subsidiary controlled group is binding on all banks that are members of such parent-subsidiary controlled group for the taxable year of the election. A parent-subsidiary controlled group is any controlled group of corporations described in section 1563(a)(1).

If, for example, an election is made to use the cut-off method in lieu of including the bad debt reserve in income, such election is binding upon all of the banks in the parent-subsidiary controlled group. Furthermore, if a member of a parent-subsidiary controlled group makes an election to include more than 10 percent of the bad debt reserve in income for the disqualification year, such election is binding upon all of the banks in the parent-subsidiary controlled group, and each such bank must include the same percentage of its bad debt reserve in income in that year.

In the case of a bank (or parent-subsidiary controlled group) that elects the cut-off method, the bill provides for inclusion in income of any portion of the bad debt reserve that exceeds the outstanding balance of loans that were created prior to the disqualification year. For example, a bank that elects the cut-off method has outstanding loans of $500 million and a bad debt reserve of $3 million as of the last day of the year year preceeding the disqualification year. Of such loans, $498 million are collected and $1 million are charged-off in the disqualification year. Thus, at the end of the disqualification year, the $2 million bad debt reserve exceeds the $1 million outstanding balance of loans. The difference ($1 million) is required to be included in income in the taxable year the difference arises.

2. Interest on debt used to purchase or carry tax-exempt obligations (sec. 109 (b) of the bill, sec. 902 of the Reform Act, and secs. 265 and 291 of the Code)

Present Law

The Act denies banks, thrift institutions, and other financial institutions a deduction for that portion of the taxpayer's otherwise allowable interest expense that is allocable to tax-exempt obligations acquired by the taxpayer after August 7, 1986 (sec. 265(b)).[1] The portion of interest disallowed is equivalent to the ratio of (1) the average adjusted basis during the taxable year of tax-exempt obligations held by the financial institution and acquired after August 7, 1986, to (2) the average adjusted basis of all assets held by the financial institution. A 20-percent disallowance continues to apply (as under pre-1986 law) with respect to tax-exempt obligations acquired between January 1, 1983, and August 7, 1986.

An exception to the proportional disallowance rule is provided for qualified tax-exempt obligations acquired by a financial institution. Qualified tax-exempt obligations include any tax-exempt obligation which (1) is not a private activity bond, as defined under Title XIII of the Reform Act,[2] and (2) is issued by an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as defined above) during the calendar year. Qualified tax-exempt obligations must be designated as such by the issuer; not more than $10 million of obligations may be so designated for any calendar year.

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[1] This rule is applied after the general disallowance rule applicable to all taxpayers (sec. 265(a)(2)).

[2] For purposes of this exception only, qualified 501(c)(3) bonds (as defined in Title XIII of the Reform Act) are not treated as private activity bonds. Additionally, certain bonds receiving transitional exceptions under Title XIII of the Reform Act, and which would not have been industrial development bonds (IDBs) or private loan bonds under prior law, are not treated as private activity bonds.

For purposes of applying the limitations with respect to qualified tax-exempt obligations, an issuer and all subordinate entities are treated as one issuer.

Qualified tax-exempt obligations are treated as if they had been acquired by the financial institution on August 7, 1986. As a result, interest allocable to such obligations remains subject to the 20 percent disallowance rule contained in pre-1986 law.

Explanation of Provisions

The bill makes several amendments to the exception for qualified tax-exempt obligations, as follows:

Application of $10 million limit

The bill clarifies that, in applying the $10 million limitation with respect to qualified tax-exempt obligations, all tax-exempt obligations (other than private activity bonds, as defined above) which the issuer reasonably anticipates to issue during the calendar year are taken into account. Thus, only an issuer that reasonably anticipates to issue $10 million or less of such obligations during the calendar year (including designated and undesignated issues) may designate any of these obligations for purposes of the exception.

Treatment of composite issues

The bill specifies the treatment of composite issues (i.e., combined issues of bonds for different entities) for purposes of the exception. An issue is a composite issue if the separate lots are sold under a common marketing arrangement that effectively provides the issuers of the separate lots access to the capital markets in a manner similar to the issuance of one issue. In order for separate lots to be treated as a composite issue, all lots need not have the same collateral or security for the lots or have cross-collaterization among lots.

Under the bill, composite issues qualify for the exception only if the requirements of the exception are met (1) with respect to the composite issue as a whole (determined by treating the composite issue as a single issue), and, additionally, (2) with respect to each separate lot of obligations which is a part of the issue (determined by treating each separate lot of obligations as a separate issue). Thus, a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if, additionally, each issuer benefiting from the composite issue reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as described above) during the calendar year, including bonds issued through the composite arrangement. The conditions under which bonds of different issuers are aggregated for purposes of the $10 million limit are described below.

Aggregation of issuers

The bill clarifies the operation of the provision under which an issuer and all subordinate entities are aggregated for purposes of the $10 million limitation. The following rules are provided:

(1) An issuer and all entities which issue bonds "on behalf of" [3] that issuer are to be treated as one issuer.

(2) If an issuer is subordinate to another entity but does not issue bonds on behalf of another entity, bonds issued by the subordinate entity are taken into account in applying the $10 million limitation to the entity to which it is subordinate.

(3) If an entity is formed or (to the extent provided in Treasury regulations) availed of for purposes of avoiding the $10 million limitation, such entity and any other entity (or entities) purporting to benefit from this device are treated as one issuer.

Treatment of refunding bonds

Under the bill, the treatment of refunding bonds also is clarified. Specifically, the following rules would apply to refundings.

Treatment of refunding obligations in determining whether issuer reasonably expected to issue more than $10 million.—Any bond whose proceeds are used to refund (other than an advance refunding) a previously issued bond is not to be taken into account for purposes of determining whether a governmental unit reasonably expected to issue more than $10 million of non-private purpose obligations.

Refunding of obligations that originally were treated as qualified tax-exempt obligations.—Any bond whose proceeds are used to refund (other than to advance refund) a previously issued obligation which was a qualified tax-exempt obligation is itself treated as a qualified tax-exempt obligation if (1) the refunded bond was designated, qualified for, and was taken into account under, under the $10 million limitation when issued,[4] (2) the aggregate face amount of the issue of which the refunding bond is a part does not exceed $10 million, and (3) except in the case of refunding of bonds having a weighed average maturity of 3 years or less, the weighted average maturity of the refunding issued does not exceed the weighted average maturity of the refunded bonds, and (4) no bond which is part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the original issue of the refunded bonds).

Refundings of obligations that originally not treated as qualified tax-exempt obligations.—Any bond whose proceeds are used to refund a previously issued obligation which was not a qualified tax-exempt obligation (e.g., the bond was issued before August 8, 1986 or an advance refunding) may be a qualified tax-exempt obligation if the refunding bond otherwise qualifies as a qualified tax-exempt obligations (i.e., (1) the refunded bond was not a private purpose bond (including any industrial development bond or private loan bond as determined under the rules prior to the Tax Reform Act of 1986), (2) the issuer reasonably expected to issue not more than $10 million of bonds (excluding any refunding bond, but including any advance refunding bonds), (3) the issuer designated the bond as part of its $10 million of designated bonds for that year, and (4) the issue of which the refunding bond is a part is not more than $10 million).

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[3] *E.g.*, Rev. Rul. 63-20, 1963-1 C.B. 24.

[4] Thus, in order for a bond to meet these requirements, the refunded bond must be (1) issued after August 7, 1986, (2) issued by an issuer that reasonably expected to issue not more than $10 million in non-private purpose obligations that year, and (3) designated by the issuer as part of its $10 million of designated bonds that year.

Designation of certain bonds issued in reliance on House bill

The bill specifies that only obligations issued after August 7, 1986, may be designated for purposes of the exception. For obligations issued after August 7, 1986, and before January 1, 1987, the period for making a designation is not to expire before January 1, 1989.

A special rule is provided for certain obligations issued before August 8, 1986, in reliance on a similar exception contained in the House version of the 1986 Act.[5] Under this rule, if (1) an obligation was issued after December 31, 1985, and before August 8, 1986, (2) when the obligation was issued, the issuer designated that it intended the obligation to qualify under section 802(e)(3) of the House bill, and (3) the issuer reaffirms its election under the 1986 Act, then the obligation is treated as issued on August 8, 1986.

Effective Date

The provisions regarding aggregation of entities, refundings, and composite issues are effective for obligations issued after June 30, 1987. (At the election of the issuer, these provisions are effective as if included in the Reform Act). Other provisions are effective as if included in the Reform Act.

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[5] H.R. 3838 (99th Congress), as passed by the House of Representatives on December 17, 1985.

X. INSURANCE PROVISIONS (SECS. 110 AND 118(h) AND (j) OF THE BILL)

1. Treatment of certain market discount bonds (sec. 110(a) of the bill and sec. 1011(d) of the Reform Act)

Present Law

The Reform Act repealed the prior-law 28 percent alternative tax rate for corporate long-term capital gains, for years for which the new corporate tax rates are fully effective (i.e., taxable years beginning on or after July 1, 1987). Thus, corporate net capital gain for such years is taxed at regular corporate rates (i.e., generally a maximum 34-percent rate under the Reform Act). For taxable years that include periods prior to the time the new rates are fully effective, the alternative tax rate under the Reform Act on gain properly taken into account under the taxpayer's method of accounting after December 31, 1986, is 34 percent. These rules apply to all items of long term capital gain, including gain attributable to market discount on bonds issued before July 19, 1984, which was treated as long-term capital gain under the transition rules of the Deficit Reduction Act of 1984.

The Deficit Reduction Act of 1984 generally required income attributable to market discount to be treated as ordinary income rather than capital gain on disposition of a bond (Code sec. 1276). However, the 1984 Act grandfathered market discount gain on bonds issued before July 19, 1984.

Under the Reform Act, a special rule is provided for gain with respect to certain bonds of certain specified life insurance companies. Pursuant to this rule, gain representing market discount recognized by such companies on the redemption at maturity of any bond which was issued before July 19, 1984, and acquired by the company on or before September 25, 1985, is subject to tax at the rate of 28 percent.

Explanation of Provision

The bill extends the special rule under the Reform Act to all life insurance companies with a modification of the tax rate to ensure that the provision has the same revenue effect as the Reform Act provision. Under the bill, the tax rate on gain subject to the special rule is 31.6 percent, rather than 28 percent.

2. Status of certain organizations providing commercial-type insurance (sec. 110(b) of the bill and sec. 1012 of the Reform Act)

Present Law

Under present law, an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (subchapter L of the Code).

Amounts derived from the activity of providing commercial-type insurance are taken into account in determining the amount of income of an exempt organization that is treated as gross income from an unrelated trade or business under the look-through rule of section 512(b)(13). The look-through rule of section 512(b)(13) is applied in the case of all payors of amounts required to be included in gross income under section 512(b)(13), whether the payor of such amounts is foreign or domestic. For example, if an exempt educational organization has a wholly owned Bermuda subsidiary (that is treated as a "controlled organization" under section 512(b)(13)), and the subsidiary is engaged in the activity of providing commercial-type insurance such that some or all of its income would have been subject to taxation under subchapter L had it been earned directly by the educational organization, then the appropriate portion of the amount of any interest, annuities, royalties, and rents paid by the subsidiary to the educational organization is included in the gross income of the educational organization as unrelated business income.

Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. Commercial-type insurance also does not include health insurance provided by a health maintenance organization (i.e., any health maintenance organization, tax-exempt under prior law, which is substantially the same as a Federally chartered health maintenance organization), if such health insurance is of a kind customarily provided by such organizations and is incidental to the organization's principal activity of providing health care. Commercial-type insurance also does not include property and casualty insurance provided by certain church organizations or conventions or associations of churches, if certain requirements are met.

The provision does not apply to certain organizations, including Delta Dental Plans Association and the Missouri Hospital Association.

Explanation of Provision

The exceptions from the provision for Delta Dental Plans Association and for the Missouri Hospital Association are restated to apply to Delta Dental Plans Association organizations and to the Missouri Hospital Plan, respectively.

The bill also provides Treasury regulatory authority to prescribe rules providing proper adjustments in the case of organizations that have a fiscal taxable year and that become subject to tax by reason of the provision, if the organization has a short taxable year that begins during 1987 by reason of rules requiring property and casualty insurance companies generally to have a calendar taxable year. It is intended that these regulations will allow a plan having a net operating loss in its first taxable year to utilize the loss fully in subsequent years rather than being required to pro rate the loss. In addition, for purposes of calculating adjusted surplus and unpaid losses, the relevant time for determination of the prior year's closing balances is the close of the last fiscal year ending before the plan's first taxable year.

3. Inclusion in income of 20 percent of unearned premium reserve (sec. 110(c) of the bill, sec. 1021 of the Reform Act, and sec. 832(b)(7) of the Code)

Present Law

Present law, as amended by the Reform Act, provides that a property and casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. In addition, such companies are required to include in income 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, ratably over the 6 taxable years following such year.

The provision requiring ratable inclusion of the pre-1987 unearned premium reserve applies to a company without regard to whether the company had computed its taxable income by taking into account additions to an unearned premium reserve. Thus, the ratable inclusion rule applies, under the Reform Act, to organizations that were exempt from Federal income tax prior to 1987 and to small companies that were taxed solely on investment income.

The Reform Act did not provide special rules for reciprocal insurers.

Explanation of Provision

Treatment of certain formerly exempt companies.—The bill provides that if, at all times prior to its 1987 taxable year, a company was exempt from tax under section 501(a) by virtue of being described in a paragraph of section 501(c), or was a small company subject to tax only on investment income, then the ratable inclusion rule does not apply. This clarification reflects the intent that no inclusion of prior reserve amounts is appropriate if the company received no tax benefit from the reserve amounts due to its former fully or partially tax-exempt status.

Phase-in treatment.—The bill also adjusts the period over which inclusion of 20 percent of the outstanding balance of the unearned premium reserve is required in the case of a company that (1) is exempt from tax under section 501(a) by virtue of being described in any paragraph of section 501(c), or is subject to tax only on investment income for its first taxable year beginning after 1986; and (2) was subject to tax as a property and casualty insurance company in a year beginning before 1987. Such companies generally computed taxable income taking into account a reserve for the gross amount of unearned premiums. In such a case, the 20-percent ratable inclusion rule applies for the 6-year period that begins with the first taxable year after 1986 in which the company is subject to tax under section 831(a). Thus, if a company was taxable at some time before 1987, is tax exempt in 1987, and again becomes taxable in a year after 1987, it is appropriate to apply the ratable inclusion rule to the company to provide treatment consistent with other companies that were taxable before 1987.

Treatment of reciprocal insurers.—The bill provides that, in the case of an interinsurer or reciprocal underwriter (within the meaning of sec. 835) that is required under applicable State law to report on its annual statement reserves for unearned premiums net of premium acquisition expenses, the amount of the unearned premiums is to be treated as including an amount equal to such expenses for purposes of the decrease in the deduction for unearned premiums. Absent such a rule, reciprocals and interinsurers would be subject to ratable inclusion of a portion of the unearned premium reserve that did not give rise to mismatching of income and deductions under prior law, which the ratable inclusion rule was intended to address.

4. Treatment of certain dividends and tax-exempt interest (sec. 110(d) of the bill, sec. 1022 of the Reform Act, and sec. 832(b)(5) of the Code)

Present Law

Present law, as amended by the Reform Act, provides that the deduction of a property and casualty company for losses incurred is reduced by 15 percent of (1) the property and casualty insurance company's tax-exempt interest, and (2) the deductible portion of dividends received (with special rules for dividends from affiliates). For purposes of this proration provision, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in income.

In the case of dividends from affiliates that are 100 percent deductible, the 15-percent reduction applies only to the portion of the dividend that is attributable to tax-exempt interest and the deductible portion of dividends received (sec. 832(b)(5)(D)(ii)(II)). This "look through" rule applies to a dividend received by a foreign corporation from a domestic corporation that would have been 100 percent deductible if the foreign corporation had been a domestic corporation. Thus, for example, if a foreign property and casualty company receives a dividend from a wholly owned subsidiary that would be eligible for the 100 percent dividend received deduction of section 243(a) but for section 243(b)(5), the dividend is subject to the look through rule. That is, the reserve deduction of the recipient corporation is reduced to the extent the dividend represents tax-exempt interest or deductible dividends received (directly or indirectly) by the payor corporation.

The same rule applies under the present-law life insurance company proration provisions (see sec. 805(a)(4)(E)). Both section 832(b)(5)(D)(ii)(II) and section 805(a)(4)(E) operate to include dividends received by foreign corporations under the proration look through rules; they do not give foreign corporations a deduction for dividends received.

The proration rule applies to tax-exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired after August 7, 1986. In the case of affiliates, special rules apply to determine the date of acquisition of stock or obligations. One of the special rules provides that the transfer of tax-exempt bonds among affiliates after August 7, 1986, is treated as an acquisition of the bonds after August 7, 1986.

Explanation of Provision

Dividends within consolidated groups.—The bill clarifies the treatment of dividends received for purposes of applying the proration provision in the case of a property and casualty insurance company that files a consolidated return. Under the bill, the determination with respect to any dividend paid by a member to another member of an affiliated group filing a consolidated return is made as if the group were not filing a consolidated return.

Lower tier subsidiaries.—The bill also clarifies that the deductible portion of any dividends received from a subsidiary, including those received directly or indirectly from a lower tier subsidiary, are subject to the proration rules in the hands of the property and casualty insurance affiliate. These provisions conform to the application of the proration rules generally to all property and casualty insurance companies.

Transfers of stock or obligations among property and casualty company affiliates.—The bill also modifies the special rules applicable for purposes of determining under the proration rule whether any stock or obligation (the interest on which is exempt from tax) acquired from an affiliate was acquired after August 7, 1986. The bill provides that stock or obligations transferred between property and casualty insurance companies that are members of the same affiliated group filing a consolidated return are treated as acquired on the date acquired by the transferor company, if (1) the transferor company acquired such stock or obligation before August 8, 1986, and (2) the two companies were members of the same affiliated group filing a consolidated return at all times after the transferor company first acquired the stock or obligation and before the transferor company transferred it to the affiliate.

The date on which a transferor company is treated as acquiring stock is determined with regard to any prior transfer of stock qualifying for treatment under the preceding sentence.

These rules apply only in the case of property and casualty insurance companies that are members of the same affiliated group filing a consolidated return. Thus, for example, any stock or obligation that is transferred by an affiliate that is not a property and casualty insurance company is treated as acquired by the transferee on the date of the transfer.

It is intended that the separate return limitation year ("SRLY") provisions of the consolidated return regulations (Treas. Reg. sec. 1.1502-1 et seq.) apply to limit the use of transferor company (or other affiliate) losses arising in any year prior to the time that the transferor and acquiror companies were members of the same consolidated group, following a transfer of stock or obligations treated as occurring before August 8, 1986, under this provision.

It is intended that stock or obligations of a property and casualty company that undergoes a mere change in identity, form, or place of organization (an "F" reorganization within the meaning of sec. 368(a)(1)(F)) after August 7, 1986, not be treated as acquired after such date solely by reason of the reorganization. Similarly, it is not intended that an F reorganization of a property and casualty company that is a member of an affiliated group filing a consolidated return cause the company to be treated as a new member of the group after the F reorganization, for purposes of the requirement that the company be a member of the group for the entire period after the transferor acquires stock or obligations and before it transfers stock or obligations to another property and casualty member of the group.

5. Loss reserves (sec. 110(e) of the bill, sec. 1023 of the Reform Act, and sec. 846 of the Code)

Present Law

The Reform Act required discounting of the deduction for additions to loss reserves of property and casualty insurance companies to take account partially of the time value of money. The discounting of such deductions is applicable to loss reserves of property and casualty companies, and to loss reserves of life insurance companies that are not required to be discounted under life insurance reserve rules. Special rules are provided in the case of certain accident and health, international, and reinsurance lines of business. The discounting of loss reserves is effective for taxable years beginning after 1986, with a fresh start provision with respect to undiscounted loss reserves applicable to the last taxable year beginning before 1987.

Explanation of Provisions

The bill clarifies that, with respect to the special rule for discounting unpaid loss reserves in certain accident and health lines of business (other than unpaid losses relating to disability income), it is assumed that unpaid losses are paid in the middle of the year following the accident year. This assumption is intended to conform to the assumption generally made for loss reserve discounting purposes that losses are paid in the middle of the year.

The bill provides that the Secretary may prescribe regulations to determine appropriate adjustments in the application of the unpaid loss discounting provisions, in the case of a taxpayer having a taxable year other than the calendar year. Although most property and casualty companies have a calendar taxable year, some companies filing a consolidated return with noninsurance companies may have a fiscal taxable year. The Reform Act did not provide special rules that are to be used in applying the discounting rules to such fiscal year taxpayers.

The regulations also are to provide appropriate adjustments in the application of the discounting provisions in cases in which the Reform Act resulted in a required change in a company's period of accounting (e.g., if the Reform Act results in the application for the first time of sec. 843, which generally requires property and casualty insurance companies to utilize a calendar taxable year).

The bill also clarifies the application of the fresh start provision in the case of an insurance company that (1) is exempt from tax under section 501(a) by virtue of being described in any paragraph of section 501(c) or, under section 831(b), is taxed only on investment income, in a year beginning after 1986, and (2) later becomes subject to tax under section 831(a) as a regular property and casualty insurance company. The rules relating to the fresh start under the discounting provisions are to be applied by treating the last taxable year before the year in which such a company becomes subject to tax under sec. 831(a) as the company's last taxable year beginning before 1987.

6. Election to be taxed only on investment income (sec. 110(f) of the bill, sec. 1024 of the Reform Act, and sec. 831(b) of the Code)

Present Law

The Reform Act provided that mutual and stock property and casualty insurance companies with net written premiums or direct written premiums (whichever is greater) in excess of $350,000, but less than $1,200,000, may elect to be taxed only on taxable investment income.

Explanation of Provisions

The bill clarifies that the election to be taxed only on investment income, once made and so long as the requirements for the election are met, may be revoked only with the consent of the Secretary. This clarification reflects Congress' intent that the election not be used as a means of eliminating tax liability (e.g., by making the election only for years when the taxpayer does not have net operating losses), but rather as a simplification for small companies.

7. Treatment of Physicians' and Surgeons' Mutual Protection Associations (sec. 110(g) of the bill and sec. 1031 of the Reform Act)

Present Law

Under the Reform Act, initial contributions to a pooled malpractice insurance association are currently deductible to the extent they do not exceed the cost of a commercial insurance premium for annual coverage and are included in the association's income. Refunds of such contributions are deductible to the fund only to the extent included in the income of the recipient. The Reform Act provision applies to associations operating under State law prior to January 1, 1984.

Explanation of Provision

The bill clarifies that initial contributions to a pooled malpractice insurance association under the provision include otherwise qualifying contributions whether paid all in one year or in a series of substantially equal payments over a period that does not exceed

6 years. Members of the association are intended to include provisional members (i.e., those association members who have paid one or more, but not all, of the annual installments of their initial contribution).

8. Special rule for a mutual life insurance company (sec. 110(h) of the bill and sec. 217(i) of the Deficit Reduction Act of 1984)

Present Law

The Deficit Reduction Act of 1984 provided that a mutual life insurance company may elect to treat all individual noncancellable (or guaranteed renewable) accident and health contracts as through they were cancellable for purposes of determining under section 816 whether or not it is subject to tax as a life insurance company or a property and casualty insurance company. Stock life insurance subsidiaries of electing mutual companies are treated as though they were mutual life insurance companies.

Explanation of Provision

The bill provides that, for purposes of determining the amount of the small life insurance company deduction of a controlled group including an electing mutual company, the taxable income of the electing company is taken into account in applying the phaseout of the small life insurance company deduction, for taxable years beginning after 1986 and before 1992. The bill further provides that the decrease in the amount of Federal revenue by reason of this provision shall not exceed $300,000 per taxable year.

9. Annuity diversification requirements (sec. 110(i) of the bill, sec. 1821(m) of the Reform Act, and sec. 817(h) of the Code)

Present Law

Present law provides that certain variable contracts that are based on a segregated asset account generally are not treated as annuity contracts if the investments made by such account are not (as provided in Treasury regulations) adequately diversified. No special rule is provided for immediate annuities. Treasury regulations were published September 12, 1986, setting forth requirements for adequate diversification of certain variable contracts, including immediate annuities.

Explanation of Provision

The bill provides additional time to comply with the annuity diversification requirement, in the case of variable contracts that are immediate annuities (as defined in sec. 72(u)(4)) that were issued by September 12, 1986, and that do not (as of that date) meet the diversification requirements set forth in the September 12, 1986, regulations because the investments made by the segregated asset accounts under the contracts were invested in Government-guaranteed investments (FDIC- or FSLIC-guaranteed deposits). In such cases, the diversification requirement with respect to Government securities (including Government-guaranteed investments) is waived until December 31, 1988, but applies in full on and after January 1, 1989.

10. Treatment of alternative minimum tax with respect to shareholders surplus account (sec. 110(j) of the bill and sec. 815(c) of the Code)

Present Law

Present law provides that, in the case of a stock life insurance company having an existing policyholder surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of amounts eligible for distribution before a distribution is made from the policyholders surplus account (and, generally, is taxable to the distributing company). In general, the excess of the following amounts over the taxes paid for the year are added to the shareholders surplus account: (1) life insurance company taxable income (but not below zero); (2) the small life insurance company deduction; (3) the dividends received deduction allowed; and (4) excluded tax-exempt interest.

Explanation of Provision

The bill provides that, under regulations, in determining additions to the shareholders surplus account, proper adjustments are to be made for any year in which alternative minimum tax is imposed under section 55 of the Code and for all subsequent years. The provision was intended to take account, in calculating the amount in the shareholders surplus account, of net tax liability of the company, and thus should take into account minimum tax and the minimum tax credit.

11. Treatment of certain items as not interest for source rules (sec. 110(k) of the bill, sec. 1215 of the Reform Act, and sec. 818(f) of the Code)

Present Law

The legislative history of the Reform Act indicates that deductions of life insurance companies that are described in Code section 807(c)(1), (2), (3), and (6) should not be treated as interest expenses, under the source rules, for allocation purposes (new Code sec. 864(e), added by section 1215 of the Reform Act). This language could lead to the inference that deductions described in section 807(c)(4) and (5) are interest expenses for allocation purposes.

Explanation of Provision

The bill clarifies that deductions of life insurance companies that are described in Code section 807(c) (which includes paragraphs (1) through (6)) are not to be treated as interest expenses for allocation purposes under new Code section 864(e), added by section 1215 of the Reform Act.

12. Technical corrections to the Deficit Reduction Act of 1984 (secs. 118(h) and (j) of the bill, secs. 1821 and 1825(a)(4) of the Reform Act, and secs. 812(e) and 7702 of the Code)

Present Law

Determination of policyholders' share of gross investment income.—Present law provides that the policyholders' share of tax-exempt interest reduces a life insurance company's deduction for certain reserves. For purposes of determining the policyholders' share, section 812(e) provides that gross investment income excludes any dividend received by the life insurance company that is a 100-percent dividend. Whether a dividend is a 100-percent dividend is determined by reference to the definition in section 805(a)(4)(C), not including dividends described in section 805(a)(4)(D). The Reform Act modified the provisions of sections 805(a)(4)(C) and (D).

Certain policies to cover burial or funeral expenses.—Present law, as amended by the Reform Act, provides that future increases in death benefits may be taken into account in determining whether the definition of a life insurance contract is satisfied with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses. Such contracts can qualify as life insurance contracts, provided that certain requirements (relating to limitations on increases in the death benefit) are satisfied. The Reform Act provided no specific effective date for the provision.

Explanation of Provisions

Determination of policyholders' share of gross investment income.—The bill clarifies that the prior-law definition of 100-percent dividends continues to apply for purposes of determining gross investment income within the meaning of section 812. Thus, the provision is intended to retain the definition as under prior law.

Certain policies to cover burial or funeral expenses.—The bill provides that the rule that future increase in death benefits may be taken into account under the definition of a life insurance contract, with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses, is effective for contracts entered into on or after October 22, 1986. Congress intended that the provision be prospectively effective.

XI. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; ESOPS (SECS. 111, 111A, 111B, 118(q), AND 203(e) OF THE BILL)

A. Limitations on Treatment of Tax-Favored Savings

1. Individual retirement arrangements (IRAs) (sec. 111(a) and (b) of the bill, secs. 1101 and 1102 of the Reform Act, and secs. 219, 408, 4973, and 6693 of the Code)

a. IRA deduction limit

Present Law

Under present law (sec. 219), a taxpayer is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual) if:

(1) in the case of a taxpayer who is not married or is married but files a separate return, the taxpayer either (a) has adjusted gross income (AGI) that does not exceed the applicable dollar amount or (b) is not an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year; or

(2) in the case of married taxpayers filing a joint return, either (a) the couple has AGI that does not exceed the applicable dollar amount or (b) neither spouse is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year.

The applicable dollar amount is (1) $25,000, in the case of an unmarried individual, (2) $40,000, in the case of a married couple filing a joint return, and (3) $0, in the case of a married taxpayer filing separately. The otherwise applicable IRA dollar limit (i.e., $2,000) is reduced by an amount that bears the same ratio to such dollar limit as the taxpayer's AGI in excess of the applicable dollar amount (or, in the case of a married couple filing a joint return, the couple's AGI in excess of the applicable dollar amount) bears to $10,000.

Explanation of Provision

Present law creates an unintended incentive for married couples to file separate returns. If one spouse is an active participant and the other spouse is not, the couple can increase their IRA deduction limit under certain circumstances by filing separate returns.

In order to eliminate this incentive for a married couple living together, the bill provides that, for purposes of determining whether an IRA contribution is deductible for a taxable year, if the couple lives together at any time during the year, the active participant status of both spouses is taken into account for purposes of calculating the IRA deduction limit. If the spouses file separate returns, the applicable dollar amount is $0 and only the AGI of the spouse making the IRA contribution is taken into account.

Also under the bill, a taxpayer is not considered married for a year if the taxpayer and the taxpayer's spouse (1) did not live together at any time during the taxable year, and (2) did not file a joint return for the taxable year. A taxpayer meeting these requirements for a taxable year is treated as an unmarried individual for the taxable year. Accordingly, for purposes of determining the taxpayer's deduction limit, only the taxpayer's AGI and status as an active participant is taken into account, and the applicable dollar amount is $25,000.

These provisions apply to contributions for taxable years beginning after December 31, 1987, except that a taxpayer may elect to have the provisions apply to contributions for taxable years beginning after December 31, 1986. The election may be made by treating IRA contributions in a manner consistent with these provisions on the taxpayer's income tax return for any taxable year beginning before January 1, 1988.

b. Nondeductible IRA contributions

Present Law

Under present law, an individual is permitted to make designated nondeductible IRA contributions to the extent that deductible contributions are not allowed due to the AGI phaseout for active participants. In addition, a taxpayer may elect to treat otherwise deductible IRA contributions as nondeductible.

An individual who makes a designated nondeductible contribution to an IRA for a taxable year or who receives a distribution from an IRA during a taxable year is required to provide such information as the Secretary may prescribe on the individual's tax return for the taxable year and, to the extent required by the Secretary, for succeeding taxable years (or on such other form as the Secretary may prescribe). The information that may be required includes, but is not limited to, (1) the amount of designated nondeductible contributions for the taxable year, (2) the amount of distributions from individual retirement plans for the taxable year, (3) the aggregate amount of designated nondeductible contributions for all preceding taxable years which have not previously been withdrawn, and (4) the aggregate balance of all IRAs of the individual as of the close of the calendar year with or within which the taxable year ends. An individual who overstates the amount of designated nondeductible contributions for a year is subject to a penalty of $100 for each overstatement unless it is shown that the overstatement is due to reasonable cause.

Explanation of Provision

Under present law, there is no separate penalty with respect to an individual who fails to file the form prescribed by the Secretary with respect to nondeductible IRA contributions. Accordingly, under the bill, a taxpayer who fails to file the form required by the Secretary is subject to a penalty of $50 for each such failure unless the taxpayer shows that the failure is due to reasonable cause.

In order to take into account taxpayers with fiscal year taxable years, the bill provides that the information that the Secretary may require to be included on the form or return includes the aggregate balance of all IRAs of the individual as of the close of the calendar year in which the taxable year begins (rather than the calendar year with or within which the taxable year ends).

c. IRA withdrawals

Present Law

Present law provides that amounts withdrawn from an IRA during a taxable year are includible in income for the taxable year under rules similar to the rules applicable to qualified plans under section 72. Under special rules applicable to IRAs for purposes of section 72, (1) all IRAs of an individual (including rollover IRAs and simplified employee pensions (SEPs), but excluding deductible qualified voluntary employee contributions), are treated as 1 contract, (2) all distributions that are made during a taxable year are treated as 1 distribution, (3) the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year with or within which the taxable year ends, and (4) the aggregate amount of withdrawals excludable from income for all taxable years shall not exceed the taxpayer's investment in the contract for all taxable years.

Explanation of Provision

Under the bill, for purposes of applying the special IRA rules of section 72, the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year in which the taxable year begins (rather than the calendar year with or within which the taxable year ends). The provision is intended to facilitate computations with respect to taxpayers with fiscal year taxable years.

d. Excess contributions

Present Law

Distribution prior to due date of return

Under present law (sec. 408(d)(4)), the normal rules for the taxation of distributions (sec. 72) do not apply to a distribution of contributions to an IRA (and, consequently, the contributions are not taxed upon distribution) if (1) the contributions exceed the amount allowable as a deduction under section 219, (2) the distribution is received on or before the due date (including extensions) for the individual's return for the taxable year, (3) no deduction is allowed under section 219 with respect to the excess contributions, and (4) the distribution is accompanied by the amount of net income attributable to the excess contributions. The net income on the contributions is deemed to have been earned and receivable in the taxable year in which the excess contributions were made.

Distribution after due date of return

If the total contributions made to all IRAs for a year (excluding rollover IRAs) does not exceed $2,250, then, under present law, the normal rules for the taxation of distributions (sec. 72) do not apply to a distribution of contributions in excess of the amount allowable as a deduction under section 219 if the excess contributions are distributed after the due date (including extensions) for filing the individual's tax return for the year the contributions were made (sec. 408(d)(5)). For purposes of this rule, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) is increased by the nondeductible limit under section 408(o)(2)(B).

Excise tax

Present law provides a 6-percent nondeductible excise tax on contributions to an IRA in excess of the amount allowable as a deduction under section 219 for a taxable year, if the excess contributions are not timely distributed (sec. 4973(b)). For purposes of this rule, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) is increased by the nondeductible limit under section 408(o)(2)(B).

Explanation of Provision

Distribution prior to due date of return

The bill amends the rules relating to distributions of excess contributions to take into account the fact that nondeductible contributions may be made to an IRA. The bill permits any IRA contributions to be distributed without income or excise tax consequences prior to the due date (including extensions) for filing the individual's income tax return for the year the contributions are made. Thus, under the bill, the normal rules for the taxation of IRA distributions do not apply to a distribution of any contributions to an IRA if (1) the distribution is received on or before the due date (including extensions) for the individual's return for the taxable year for which the contributions were made, (2) no deduction is allowed under section 219 with respect to the contributions, and (3) the distribution is accompanied by the amount of net income attributable to the contributions. As under present law, net income on the contributions are deemed to have been earned and receivable in the taxable year in which the contributions were made.

Distribution after due date of return

The bill clarifies that certain IRA contributions not in excess of $2,250 may be withdrawn by providing that, for purposes of the rule relating to return of excess contributions after the due date of the individual's return for the year for which the contributions were made, the amount allowable as a deduction under section 219 is computed without regard to the AGI phaseout for active participants (sec. 219(g)).

Excise tax

The bill provides that, for purposes of the excise tax on excess contributions to an IRA, the amount allowable as a deduction under section 219 is computed without regard to the AGI phaseout for active participants (sec. 219(g)).

2. Qualified cash or deferred arrangements (sec. 111(c) and (l) of the bill, secs. 1105, 1116, and 1879 of the Reform Act, and secs. 401(k), 402, and 4979 of the Code)

a. Limit on elective deferrals

Present Law

In general

Present law provides that the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. This $7,000 limit is indexed for inflation at the same time and in the same manner as the indexing of the dollar limit on benefits under section 415(d). For 1988, the indexed limit is $7,313. The limit applies to the employee's taxable year, regardless of the employer's taxable year or the plan year applicable to the cash or deferred arrangement. The limit is coordinated with other plans to which elective deferrals are made.

To ease the administrative burden on employees, employers, and the IRS, the elective deferral arrangements maintained by any single employer may preclude an employee from making elective deferrals under such arrangements for a taxable year in excess of $7,000 (indexed)

Treatment of excess deferrals

If, for any taxable year, the total amount of elective deferrals contributed on behalf of an employee to all qualified cash or deferred arrangements and other plans subject to the limit exceeds $7,000 (indexed), then the amounts in excess of $7,000 (indexed) (the excess deferrals) are included in the employee's gross income for the taxable year to which the deferral relates. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the qualified cash or deferred arrangements and other plans subject to the limit and notify the administrator of each plan of the portion of the excess deferrals allocated to that plan. Not later than April 15 after the close of the employee's taxable year, each plan may (but is not required to) distribute to the employee the amount of the excess deferrals (plus income attributable to the excess deferrals) allocated to the plan.

Generally, the distribution may be made without regard to the terms of the plan until the close of the first plan year for which an amendment is required (Act sec. 1140) and notwithstanding any other provision of law. In addition, the Secretary is to prescribe a model plan amendment that permits the distribution of excess deferrals. Distribution pursuant to such amendment is to be treated as in accordance with the plan.

Income on excess deferrals distributed by the applicable April 15 date is treated as earned and received in the taxable year to which the excess deferral relates. Excess deferrals (and earnings thereon) distributed by the applicable April 15 date are not subject to the additional income tax on early withdrawals (sec. 72(t)). Deferrals are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess deferrals.

Reporting requirements

Under the Act, the employer is required to report to an employee and to the IRS the amount of elective deferrals made by the employee and the amount of compensation deferred under section 457 (sec. 6051(a)).

Explanation of Provision

In general

The bill provides that income on excess deferrals is includible in gross income in the year distributed, rather than in the year of the deferral. To prevent individuals from electing to make excess deferrals in order to defer current taxation of income, the bill requires, as a condition of qualification, that a plan that has a cash or deferred arrangement provide that elective deferrals under the arrangement and under all other plans, contracts, or arrangements of the employer maintaining the plan for a calendar year may not exceed the limitation on elective deferrals in effect for taxable years beginning in such calendar year. A similar restriction is required to be included in a simplified employee pension (SEP) (sec. 408(k)), tax-sheltered annuity contract (sec. 403(b)), or section 501(c)(18) plan that permits elective deferrals. The bill provides that, for purposes of the required plan provision, the limit on elective deferrals need not be explicitly set forth, but can be incorporated by reference.

The provision is generally effective with respect to plan years beginning after December 31, 1987. A delayed effective date applies in the case of certain plans maintained pursuant to a collective bargaining agreement with respect to contributions made pursuant to the bargaining agreement.

Treatment of excess deferrals

Under the bill, income on excess deferrals distributed before the applicable April 15 date, including income earned during and after the year to which the deferral relates, is includible in income in the year distributed, rather than in the year to which the deferral relates. The bill clarifies that any distribution of less than the entire amount of excess deferrals plus income attributable to such deferrals is treated as a pro rata distribution of excess deferrals and income.

The bill clarifies that excess deferrals (and income on such deferrals) distributed by the applicable April 15 are not subject to the 15-percent tax on excess distributions (sec. 4980A).

Reporting requirements

The Act did not contain an effective date for the reporting requirement relating to elective deferrals. The reporting requirement was intended to be effective at the same time the Act's limit on elective deferrals was effective. Accordingly, the bill provides that the requirement is effective with respect to calendar years beginning after December 31, 1986.

b. Nondiscrimination requirements

Present Law

Under present law, a special nondiscrimination test applies to limit the elective deferrals that may be made by highly compensated employees. The limit depends (in part) on the level of elective deferrals by nonhighly compensated employees. A cash or deferred arrangement under which only highly compensated employees participate or are eligible to participate does not satisfy the special nondiscrimination test. For purposes of applying the special nondiscrimination test, under rules prescribed by the Secretary, employer matching contributions that are nonforfeitable and that satisfy certain withdrawal restrictions may be taken into account.

If the special nondiscrimination rules are not satisfied for any year, present law provides that the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then recontributed by the employee to the plan on an after-tax basis. Such recharacterization is not permitted in the absence of regulations. A plan may provide that an employee is required to make such a recharacterization election as a condition of plan participation.

Generally, distribution of excess contributions may be made notwithstanding any provision of the plan until the first plan year for which plan amendments are required (Act sec. 1140) and notwithstanding any other provision of law. In addition, the Secretary is to prescribe a model plan amendment that permits the distribution of excess contributions. Distribution pursuant to such amendment is to be treated as a distribution made in accordance with the plan. The amount distributed is not subject to the 10-percent additional income tax on early withdrawals (sec. 72(t)). Contributions are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess contributions.

Prior to the Deficit Reduction Act of 1984 (DEFRA), proposed Treasury regulations permitted a cash or deferred arrangement that failed the special nondiscrimination test to be qualified if the arrangement satisfied the general nondiscrimination rules (sec. 401(a)(4)). DEFRA provided that a cash or deferred arrangement is not qualified unless it satisfies the special nondiscrimination test, with an exception provided in DEFRA section 527(c)(1)(B). Although the Act modified the nondiscrimination requirements, it did not change the rule enacted in DEFRA section 527(c)(1)(B).

For a discussion of the excise tax on excess contributions and excess aggregate contributions (sec. 4979), see below.

Explanation of Provision

The bill clarifies that, for purposes of the special nondiscrimination test, the elective deferrals of eligible highly compensated employees, rather than all highly compensated employees, are taken into account. Under prior law, highly compensated employees were defined by reference to eligible employees. However, the new uniform definition of highly compensated employees does not refer to eligible employees and, therefore, the clarification is necessary to obtain a result consistent with prior law.

The bill provides that, for purposes of determining whether matching contributions may be used to satisfy the special nondiscrimination test for elective deferrals and for purposes of the vesting rules (sec. 411), a matching contribution is not treated as forfeitable merely because the matching contribution is forfeited because the contribution to which it relates is an excess deferral (sec. 402(g)(2)(A)), an excess contribution (sec. 401(k)(8)(B)), or an excess aggregate contribution (sec. 401(m)(6)(B)). The bill clarifies that excess contributions distributed (or treated as distributed) by the end of the plan year following the year the excess contributions arose are not subject to the excise tax on excess distributions (sec. 4980A).

c. Withdrawal restrictions

Present Law

Under present law, withdrawals generally are not permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan or a rural electric cooperative plan) the attainment of age 59-1/2. However, a qualified cash or deferred arrangement (other than a pre-ERISA money purchase pension plan or a rural electric cooperative plan) may permit hardship withdrawals up to the amount of the employee's elective deferrals (but not income on the elective deferrals).

In addition, under the Act, distributions may be made from a qualified cash or deferred arrangement upon (1) termination of the plan without the establishment of a successor plan, (2) the date of sale by a corporation of substantially all of the assets used by the corporation in a trade or business if the employee continues employment with the corporation acquiring the assets, or (3) the date of the sale by a corporation of the corporation's interest in a subsidiary if the employee continues employment with the subsidiary. The Statement of Managers for the Act provided that a distribution upon any of these 3 events is permitted only if the distribution constitutes a total distribution of the employee's balance to the credit in the cash or deferred arrangement.

Explanation of Provision

As originally enacted, the exception to the withdrawal restrictions for certain sales of assets or subsidiaries does not encompass other transactions that have the effect of sales of assets or subsidiaries. The bill expands the exception to include certain dispositions of assets or subsidiaries other than sales and clarifies that the exception only applies if the transferor corporation continues to maintain the plan after the disposition. Thus, the bill provides that distributions can be made from a qualified cash or deferred arrangement on the (1) disposition by a corporation of substantially all of the assets (within the meaning of sec. 409(d)(2)) used by such corporation if the employee continues employment with the transferee corporation and the transferor corporation continues to maintain the plan, or (2) disposition by a corporation of the corporation's interest in a subsidiary (within the meaning of sec. 409(d)(3)) if the employee continues employment with the subsidiary and the transferor corporation continues to maintain the plan.

The bill incorporates statutorily the requirement that a distribution must be a total distribution in order for the exceptions for dispositions of assets or subsidiaries or for termination of a plan to apply. Under the bill, with respect to distributions after March 31, 1988, these exceptions only apply if the distribution is a "lump sum distribution." For this purpose, "lump sum distribution" means a lump-sum distribution under the income averaging rules (sec. 402(e)(4)), but without regard to (1) the required events (such as attainment of age 59-1/2) for eligibility for income averaging, (2) the election requirement, and (3) the minimum period of plan participation requirement. Thus, for this purpose, a distribution can constitute a lump-sum distribution even though, for example, the employee receives the distribution prior to age 59-1/2, has already elected lump-sum treatment for a prior distribution, or has not been a participant in the plan for at least 5 years.

The bill also provides that with respect to distributions after October 16, 1987, the exception to the withdrawal restrictions for the termination of the plan is conditioned on the employer not establishing or maintaining another defined contribution plan for a reasonable period established by the Secretary.

d. Other restrictions

Present Law

Under the Act, a cash or deferred arrangement is not qualified if any employer contributions or benefits (other than matching contributions) are conditioned (either directly or indirectly) upon an employee's elective deferrals. The Statement of Managers provides that this prohibition is not limited to employer-provided benefits. The prohibition also is not limited to benefits provided under a qualified plan, but also applies, for example, to benefits provided under a health plan or under a nonqualified deferred compensation arrangement.

The Act prohibits (1) tax-exempt organizations and (2) State and local governments and political subdivisions thereof, and agencies and instrumentalities thereof, from establishing qualified cash or deferred arrangements.

The prohibition does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local govern-

ment), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided. Similarly, plans that are grandfathered may be amended in the future. Most such plans will, of course, have to be amended to take into account the new requirements relating to qualified cash or deferred arrangements. Other plan amendments may also be made. For example, a grandfathered plan may be amended in the future to provide for employer matching contributions, to modify the level of employer matching contributions, or to provide that the qualified cash or deferred arrangement is part of a cafeteria plan.

The Act provides that a qualified cash or deferred arrangement can be part of a rural electric cooperative plan, but does not explicitly exempt such plans from the prohibition on maintenance of cash or deferred arrangements by tax-exempt and State and local government employers. The Act defines a rural electric cooperative plan as a defined contribution plan (as defined in sec. 414(i)) that is established and maintained by a rural electric cooperative (as defined in sec. 457(d)(9)(B)) or a national association of such rural electric cooperatives.

Explanation of Provision

The bill reconciles the statutory provision and the intent of Congress articulated in the Statement of Managers by providing that the prohibition on conditioning benefits on elective deferrals is not limited to employer-provided benefits. Thus, for example, a plan may not provide that voluntary after-tax employee contributions may not be made until an employee makes a specified amount of elective deferrals under a qualified cash or deferred arrangement.

The bill modifies the grandfather rule applicable to section 401(k) plans maintained by governmental employers. Under the bill, the prohibition on section 401(k) plans does not apply to (1) an employer that is a State or local government or political subdivision thereof, or agency or instrumentality thereof, if the employer adopted a section 401(k) plan before May 6, 1986, and (2) an employer that is a tax-exempt governmental unit other than a governmental unit described in (1) (e.g., the Tennessee Valley Authority), if the employer adopted a section 401(k) plan before July 2, 1986. Because the grandfather rule in the bill applies to the employer and not merely the plan, an employer that satisfies the conditions of the grandfather may adopt a new section 401(k) plan.

Because the identity of the employer is more likely to change in the case of tax-exempt employers that are not governmental entities (such as through a merger of unrelated tax-exempt organizations), the bill limits this expansion of the grandfather rule to tax-exempt governmental units.

The bill clarifies that the prohibition against cash or deferred arrangements maintained by tax-exempt and State and local government employers does not apply to a rural electric cooperative plan. The bill also modifies the definition of rural electric cooperative. A change in the definition is necessary because the Code section reference in the Act defining a rural electric cooperative was repealed by the Act. Under the bill, a rural electric cooperative is (1) any organization that (i) is engaged primarily in providing electric service on a mutual or cooperative basis, and (ii) either is (I) a State or local government or political subdivision thereof, or any agency or instrumentality thereof, or (II) an organization exempt from tax under Subtitle A; (2) any organization described in paragraph (4) or (6) of section 501(c) that is exempt from tax under section 501(a) and at least 80 percent of the membership of which are organizations described in (1); and (3) an organization that is a national association of organizations described in (1) or (2). The exemption does not apply to a member of an organization described in (3), solely by reason of such membership, if the member is not itself an organization described in (1) or (2). Similarly, the exemption does not apply to a member of an organization described in (2), solely by reason of such membership, if the member is not itself an organization described in (1).

3. Nondiscrimination requirements for employer matching contributions and employee contributions (sec. 111(m) of the bill, sec. 1117 of the Reform Act, and secs. 401(m) and 4979 of the Code)

a. Special nondiscrimination test

Present Law

In general

Under present law, a special nondiscrimination test is applied to matching contributions and employee contributions, including employee contributions under a qualified cost-of-living arrangement (sec. 415(k)). This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The term "matching contributions" means any employer contribution made to the plan on behalf of an employee on account of an employee contribution or an elective deferral under a qualified cash or deferred arrangement. Forfeitures under a plan that are reallocated to participants' accounts on the basis of employee contributions or elective deferrals are, of course, also treated as matching contributions.

Required aggregation

If 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a highly compensated employee participates in 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made, then all such contributions are aggregated for purposes of the special nondiscrimination test.

Explanation of Provision

In general

Under the bill, the special nondiscrimination test applicable to matching contributions and employee contributions only applies to contributions to defined contribution plans within the meaning of sec. 414(k). Also under the bill, the definition of "matching contributions" includes any contribution to a defined contribution plan made on account of an employee contribution or an elective deferral under a qualified cash or deferred arrangement, whether such contributions are made to the same plan or a different plan. Contributions to a defined benefit pension plan may be employee contributions or matching contributions to the extent treated as contributions to a defined contribution plan (sec. 414(k)).

In accordance with the Statement of Managers with respect to the Act, the bill provides that contributions to tax-sheltered annuities that are treated as elective deferrals for purposes of the dollar limit on elective deferrals (sec. 402(g)) are also to be treated as elective deferrals for purposes of the nondiscrimination rules applicable to employer matching contributions and employee contributions (sec. 401(m)). Under the bill, this provision is subject to the effective date provisions in the Act, as amended, with respect to the application of nondiscrimination rules to tax-sheltered annuities (Act sec. 1120(c)). Thus, for example, employer contributions to any type of plan that match an elective deferral to a tax-sheltered annuity are subject to the nondiscrimination requirements of section 401(m) in years beginning after December 31, 1988 (or later under the special effective date applicable to plans maintained pursuant to a collective bargaining agreement).

As under the rules applicable to elective deferrals under a cash or deferred arrangement, elective deferrals under a tax-sheltered annuity may be used to help satisfy the nondiscrimination test applicable to matching contributions with respect to a tax-sheltered annuity. (Similarly, consistent with the rules applicable to cash or deferred arrangements, elective deferrals to a tax-sheltered annuity may not be used to help a tax-sheltered annuity program satisfy the applicable coverage tests (sec. 410(b) without regard to sec. 410(c)) except for purposes of the average benefits test.)

Under the bill, matching contributions that are treated as elective deferrals for purposes of the special nondiscrimination test applicable to cash or deferred arrangements are not subject to the special test applicable to matching contributions and employee contributions.

Required aggregation

The bill modifies the requirement with respect to aggregation of plans in which a highly compensated employee participates. Under the bill, if a highly compensated employee participates in 2 or more plans of an employer to which contributions subject to the special nondiscrimination test (sec. 401(m)) are made, then all such contributions are aggregated for purposes of the test. For example, assume an employer maintains a plan with a cash or deferred arrangement under which matching contributions are made, and a thrift plan providing for after-tax employee contributions and matching contributions. Highly compensated employees participate in both plans. Under the bill, matching contributions that are not treated as elective deferrals in applying the special section 401(k) nondiscrimination test and after-tax contributions under the plans are aggregated for purposes of the special nondiscrimination test. The elective deferrals, however, are not required to be aggregated with the matching contributions and employee contributions.

b. Treatment of excess aggregate contributions

Present Law

If the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such contributions) are distributed before the close of the following plan year. Distribution of excess aggregate contributions by such date may be made notwithstanding any other provision of law, and the amount distributed is not subject to the additional income tax on early withdrawals (sec. 72(t)). Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess aggregate contributions.

An excise tax is imposed on the employer with respect to excess contributions and excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess contributions and excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year.

However, the tax does not apply to any excess contributions or excess aggregate contributions that, together with income allocable to such contributions, are distributed (or, if nonvested, forfeited) no later than 2-1/2 months after the close of the plan year in which the contributions arose.

Excess matching contributions (plus income), excess elective deferrals (plus income), excess qualified nonelective contributions (plus income), and income on excess employee contributions distributed within the applicable 2-1/2 month period are to be treated as received and earned by the employee in the employee's taxable year to which such contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first contributions (of the type distributed) for a plan year are deemed to be excess contributions or excess aggregate contributions.

Explanation of Provision

The bill provides that excess aggregate contributions for a plan year that are distributed before the end of the following plan year are not subject to the 15-percent excise tax on excess distributions (sec. 4980A).

In addition, to be consistent with the rules applicable to excess deferrals and excess contributions, the bill provides that generally such distributions may be made without regard to the terms of the plan until the close of the first plan year for which an amendment is required (Act sec. 1140). The bill similarly provides that the Secretary is to prescribe a model amendment that allows a plan to distribute excess aggregate contributions and that a plan distribution in accordance with such amendment is to be treated as in accordance with the terms of the plan. It is understood that the Secretary has already prescribed model amendments under the Act; accordingly, it is not intended that the Secretary be required to prescribe a new amendment regarding excess aggregate contributions.

The Act provides that excess contributions and excess aggregate contributions that are distributed within 2-1/2 months after the end of the plan year are treated as received and earned by the recipient in the taxable year to which the contribution relates in order to prevent deferral of income. Such deferral is not of major concern, however, where the amount involved is not significant. Accordingly, the bill provides an exception to the general rule. Under this exception, if the total distributions of excess contributions and excess aggregate contributions under a plan for a plan year with respect to an individual are less than $100, then the distributions are treated as earned and received by the individual in the taxable year in which the distributions were made.

4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers (sec. 111(e) of the bill, sec. 1107 of the Reform Act, and sec. 457 of the Code)

a. Application to tax-exempt employers; distribution requirements

Present Law

The Act applies the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments (sec. 457) to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations.

Under the Act, distributions cannot be made available to participants or beneficiaries under a section 457 plan before the participant is separated from service with the employer or is faced with an unforeseeable emergency. In addition, distributions under a section 457 plan are required to comply with the provisions of section 401(a)(9). Under section 401(a)(9) as amended by the Act, distributions are required to begin no later than the April 1 of the calendar year following the calendar year the participant attains age 70-1/2, regardless of whether the participant is still employed. Thus, section 401(a)(9) may require that distribution is to begin before the time that distributions are permitted under section 457.

With respect to section 457 plans, the Act imposes distribution requirements in addition to those imposed by section 401(a)(9). Pursuant to one such requirement, in the case of a distribution beginning before the death of the participant, such distribution is required to be made in a form under which at least 2/3 of the total amount payable with respect to the participant will be paid during the life expectancy of such participant (determined as of the commencement of the distribution) (sec. 457(d)(2)(B)(i)(I)). This provision was modeled after the incidental death benefit rule applicable under section 401(a)(9), but was intended to require more rapid distribution than such rule.

When the Act was enacted, the incidental death benefit rule provided that the present value of benefits payable to a participant's beneficiaries generally may not exceed 50 percent of the present value of the total benefits payable with respect to the participant. Subsequently, however, the Treasury Department issued proposed regulations modifying the incidental death benefits rule. Generally, the proposed regulations contain tables providing guidelines for the form in which distributions are required to be made.

The Act provides that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump-sum payment within 60 days of the election. The 60-day rule only applies if the employee's total deferred benefit does not exceed $3,500 and no additional amounts may be deferred with respect to the employee.

Explanation of Provision

The bill reconciles the rules under section 457 and section 401(a)(9) relating to the time that distributions are to be made. With respect to the rule prohibiting distributions prior to separation from service or the occurrence of an unforeseen emergency, the bill provides an exception for distributions in or after the year in which the employee attains age 70-1/2. Thus, under the bill, amounts may not be available under a section 457 plan earlier than (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant separates from service, or (3) when the participant is faced with an unforeseeable emergency.

The bill deletes the rule contained in section 457(d)(2)(B)(i)(I). In lieu of this rule, the bill instructs the Secretary to issue tables that implement the incidental death benefit rule and that are similar to those applicable under section 401(a)(9) but require more rapid distributions. Generally, the extent to which more rapid distributions are to be required is to be similar to the extent to which the former section 457(d)(2)(B)(i)(I) rule required more rapid distributions than the former version of the incidental death benefit rule.

The bill clarifies that the exception to the constructive receipt rule with respect to an election to receive a lump-sum distribution does not override the distribution restrictions otherwise applicable to eligible deferred compensation plans. Thus, the bill provides that the exception is not available for distributions payable prior to separation from service.

b. Amount of deferrals

Present Law

Under present law, an unfunded deferred compensation plan is not an eligible plan if it permits deferred compensation in excess of the limits contained in section 457. The limit on deferred compensation under a section 457 plan is coordinated with contributions to a tax-sheltered annuity (sec. 403(b)). In addition, under the Act, the limit under section 457 is coordinated with elective deferrals under a cash or deferred arrangement, a simplified employee pension, or a plan described in section 501(c)(18). For example, if in 1988 an employee participates in a qualified cash or deferred arrangement and an eligible deferred compensation plan, the employee could elect to defer $7,313 under the cash or deferred arrangement and an additional $187 (but no more than $187) under the eligible deferred compensation plan.

Explanation of Provision

An employee may participate in a section 457 plan of 1 employer and, for example, a cash or deferred arrangement of another employer. Thus, the employer maintaining the section 457 plan may not know whether an employee is making elective deferrals to a plan that is coordinated with the section 457 plan for purposes of the limit on deferred compensation. Thus, it is not appropriate to disqualify the entire section 457 plan in such cases.

Accordingly, the bill provides that, for purposes of determining whether an unfunded deferred compensation plan is an eligible plan under section 457, the rule requiring coordination of the deferred compensation limit with other plans is disregarded. Of course, if the limit (as so coordinated) is exceeded, the deferral of income inclusion provided by section 457 does not apply to the excess; instead, the rules of section 457(f) apply to such excess.

In order to prevent avoidance of the limit on deferred compensation under a section 457 plan by, for example, the use of affiliated service groups or leasing arrangements, the bill provides that the Secretary's general regulatory authority to prevent avoidance of certain requirements (sec. 414(o)) applies to section 457 plans.

c. Effective date

Present Law

Under the Act, the requirements of section 457 do not apply to amounts deferred under a plan established by a nongovernmental tax-exempt organization with respect to an individual that (1) were deferred for taxable years beginning before January 1, 1987, or (2) are deferred for taxable years beginning after December 31, 1986, pursuant to an agreement between the organization and the individual that (a) was in writing on August 16, 1986, and (b) on August 16, 1986, provided for a deferral for each taxable year of a fixed amount or an amount determined pursuant to a fixed formula. This exception does not apply with respect to amounts deferred in a fixed amount or under a fixed formula (including a fixed formula under a plan that is in the nature of a defined benefit plan) for any taxable year ending after the date on which the amount or formula is modified after August 16, 1986. The Act was unclear as to whether a plan is required to satisfy the requirements of section 457 (i.e., be an eligible plan) in order to qualify for the grandfather.

Explanation of Provision

The bill clarifies that the grandfather rule applicable to unfunded deferred compensation arrangements of tax-exempt employers applies to all deferred compensation plans of tax-exempt organizations that otherwise meet the requirements of the grandfather rule, without regard to whether the plans would be eligible deferred compensation plans within the meaning of section 457.

It is intended that with regard to amounts deferred from taxable years beginning before January 1, 1987, the grandfather rule applies without regard to whether the organization maintaining the deferred compensation plan was tax-exempt when the plan was established. For example, assume that a deferred compensation plan is established on January 1, 1985, by a taxable organization with respect to individuals all of whose taxable year is the calendar year. The organization becomes tax-exempt on January 1, 1987. If the amounts deferred under the plan from taxable years beginning before January 1, 1987, otherwise meet the requirements of the grandfather rule, then the application of the grandfather rule to such amounts will not be affected by the fact that the organization was not tax-exempt when the plan was established. This rule is not intended to create any inference with respect to the effect of a change in taxable status for other purposes relating to section 457.

The bill also clarifies that the grandfather rule only applies to individuals who were covered under the plan and agreement on August 16, 1986. Thus, for example, the grandfather does not apply to a new employee hired after August 16, 1986, or an employee who was hired on or before such date, but who was not a participant in the deferred compensation plan until after August 16, 1986.

5. Deferred annuity contracts (sec. 111A(i) of the bill, sec. 1135 of the Reform Act, and sec. 72(u) of the Code)

Present Law

Under the Act, if any annuity contract is held by a person who is not a natural person (such as a corporation or trust), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. In the case of a contract the nominal owner of which is a person who is not a natural person, but the beneficial owner of which is a natural person, the contract is treated as held by a natural person.

The provision does not apply to any annuity contract that (1) is acquired by the estate of a decedent by reason of the death of the decedent; (2) is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA; (3) is a qualified funding asset for purposes of a structured settlement agreement (as defined in sec. 130(d), but without regard to whether there is a qualified assignment); (4) is purchased by an employer upon the termination of a qualified plan and is held by the employer until the employee separates from service; or (5) is an immediate annuity. Under the Act, an immediate annuity contract is an annuity contract (1) that is purchased with a single premium or consideration, and (2) the annuity starting date of which commences no later than 1 year from the date of purchase of the contract.

Explanation of Provision

The rule under which certain contracts will not be treated as annuity contracts was intended to apply for purposes of the Federal income taxation of the policyholder, but was not intended to extend to the tax treatment of the insurance company. Accordingly, the bill would clarify that the treatment of annuity contracts held by nonnatural persons applies generally for purposes of subtitle A of Title I of the Code, other than subchapter L.

The bill also provides that, with respect to the exception to the rule regarding treatment of annuity contracts held by nonnatural persons for an annuity that is purchased by an employer upon termination of a qualified plan, the exception applies to an annuity that is held until all amounts are distributed to the employee for whom such contract was purchased or to the employee's beneficiary.

The bill modifies the definition of an immediate annuity contract to prevent the structuring of a contract that appears to be an immediate annuity contract, but that is in substance a deferred annuity. Accordingly, the bill provides that an annuity is an immediate annuity only if the annuity provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period. An annuity will not be treated as failing to satisfy this requirement if it is an annuity payable over the joint lives of 2 or more individuals and the amounts paid to a survivor after the death of the first annuitant are less than the amounts paid during the joint lives of the annuitants.

6. Elective contributions under tax-sheltered annuities (sec. 111(c) of the bill, sec. 1105 of the Reform Act, and sec. 402 of the Code)

a. Catch-up rule

Present Law

The Act imposes a limit on elective deferrals under a tax-sheltered annuity that operates in the same manner as the limit on elective deferrals under a qualified cash or deferred arrangement. However, the annual limit on elective deferrals under a tax-sheltered annuity is $9,500, rather than $7,000 (indexed).

Thus, the limit on elective deferrals to a tax-sheltered annuity for a year is the least of the following amounts: (1) $9,500, (2) the exclusion allowance under section 403(b), or (3) the limit on annual additions under a defined contribution plan (sec. 415(c)) without regard to the catch-up rules for tax-sheltered annuities (sec. 415(c)(4)).

The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed at the same time and in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

The Act provides an exception to the $9,500 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make additional salary reduction contributions under the following conditions:

(1) In no year can the additional contributions be more than $3,000 (and, therefore, the $9,500 limit may not be increased above $12,500);

(2) An aggregate limit of $15,000 applies to the total amount of catch-up contributions (i.e., contributions that, in any year, exceed the limit on elective deferrals for that year); and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer.

This special catch-up rule provides the only rule under which elective deferrals by an individual may exceed the limit on elective deferrals for a year.

It is intended that the definition of years of service for purposes of the special catch-up election will include principles similar to the principles of section 414(a). For this purpose, an employee's years of service will be determined by including all years of service with a predecessor employer (within the meaning of sec. 414(a)). Thus, years of service with a denomination of a church that merges into or combines with another denomination generally are to be aggregated with years of service with the surviving denomination.

Explanation of Provision

The Act does not specify how years of service are to be determined for purposes of the catch-up rule. The bill provides that, for this purpose, years of service are defined as in section 403(b). This definition will provide consistency with the way years of service are generally calculated under the rules relating to tax-sheltered annuities.

It is recognized that it may be difficult for employers to calculate whether an individual's lifetime elective deferrals exceed the individual's lifetime limit for purposes of the catch-up rule because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals. Accordingly, under the bill, for purposes of calculating an individual's lifetime elective deferrals under the catch-up rule, elective deferrals for prior years are to be determined in the manner prescribed by the Secretary. Under this provision, it is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

b. Definition of elective deferrals

Present Law

Under present law, employer contributions to purchase an annuity contract under a salary reduction agreement (within the meaning of sec. 3121(a)(5)(D)) are considered elective deferrals. The Statement of Managers with respect to the Act provides that an employer contribution is not treated as an elective deferral if the contribution is made pursuant to a one-time election to participate in the tax-sheltered annuity even though such contribution would be considered made under a salary reduction agreement under section 3121(a)(5)(D).

Explanation of Provision

The bill conforms the statutory language to the legislative history by providing that contributions to a tax-sheltered annuity are not considered elective deferrals if the contributions are made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the annuity or are made pursuant to a similar arrangement specified in regulations. The bill does not change the definition of salary reduction agreement for purposes of section 3121(a)(5)(D). This amendment also does not affect the definition of elective deferrals other than with respect to tax-sheltered annuities.

7. Special rules for simplified employee pensions (sec. 111(f) of the bill, sec. 1108 of the Reform Act, and secs. 408(k) and 3401 of the Code)

a. Salary reduction SEPs

Present Law

Under the Act, employees who participate in a SEP are permitted to elect to have contributions made to the SEP or to receive the contributions in cash. If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. In addition, the contribution is not treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, under the Act, an employee is not required to include in income currently the amounts the employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

The Act provides that the tax treatment described above of the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, this exception to the constructive receipt principle is available for a taxable year only if the employer maintaining the SEP had 25 or fewer employees at all times during the prior taxable year.

In addition, under the Act, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee cannot exceed 125 percent of the average deferral percentage for all eligible nonhighly compensated employees.

If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement are to apply.

Explanation of Provision

The bill clarifies that, for purposes of the rules relating to SEPs (other than sec. 408(k)(2)(C)), the uniform definition of compensation (sec. 414(s)) applies. The bill also clarifies that, for purposes of applying the 125-percent test to a salary reduction SEP, compensation does not include compensation in excess of $200,000, indexed for increases in the cost-of-living. For 1988, the indexed limit is $208,940.

The bill clarifies that, in determining whether the employer maintaining a salary reduction SEP had more than 25 employees in the prior taxable year, only employees who were eligible to participate in the SEP (or would have been required to be eligible to participate if a SEP were maintained) are taken into account. This rule is consistent with the eligibility rules for SEPs, that is, individuals who are not required to be eligible to participate in the SEP may be disregarded in determining whether the 25-employee rule is satisfied.

The bill adds provisions designed to ensure that excess contributions to a salary reduction SEP are distributed. These rules are different from the rules relating to excess deferrals in cash or deferred arrangements because, in the case of a SEP, the employer may not force an employee to take a distribution of excess deferrals because the SEP contributions are held in an IRA which the employee controls.

The bill specifically authorizes the Secretary to prescribe appropriate rules, including rules requiring that the excess contributions (plus income) be distributed, reporting requirements, and rules providing that contributions to a SEP (plus income) may not be withdrawn until a determination that the special nondiscrimination test has been satisfied is made. In addition, the bill provides that, until such a determination has been made, any transfer or distribution from a SEP of salary reduction contributions (or income on such contributions) is subject to tax in accordance with section 72 and to the early withdrawal tax (sec. 72(t)(1)), regardless of whether an exception to the tax would otherwise be available.

Consistent with the inclusion of SEP contributions that are made pursuant to a salary reduction agreement for purposes of FICA (sec. 3121(a)(5)) and FUTA (sec. 3306(b)(5)), the bill would include such contributions for purposes of determining benefits under the Social Security Act.

b. Integration rules

Present Law

The Act eliminated the prior-law rules under which nonelective SEP contributions could be combined with employer OASDI contributions for purposes of the applicable nondiscrimination requirements. In place of these rules, the Act permits nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between the contribution percentages applicable to compensation below and compensation above the integration level. This provision is effective for years beginning after December 31, 1986. The new rules for defined contribution plans permitting a limited disparity between contribution levels are generally applicable to qualified plans for years beginning after December 31, 1988.

Explanation of Provision

The bill coordinates the effective date of the new integration rules with respect to qualified plans and SEPs. Thus, the bill provides that the integration rules applicable to SEPs (sec. 408(k)(3)(D) and (E)) prior to the Act will continue to apply to years beginning before January 1, 1989, when the new integration rules are effective. However, no integration is permitted under the 125-percent nondiscrimination test for salary reduction SEPs.

c. Income exclusion

Present Law

Under present law, contributions to SEPs are excludable from income, rather than allowable as a deduction as under prior law.

Explanation of Provision

To conform to the conversion of the SEP deduction to an exclusion, the bill provides that, for purposes of section 408(d)(4), (5) and section 4973, an amount excludable from income under section 402(h) is treated as an amount allowable as a deduction under section 219. In addition, the bill amends the definition of wages for withholding tax purposes (sec. 3401(a)(12)(C)) to provide that contributions to a SEP are not considered wages if it is reasonable to believe that the contributions will be excludable from income (rather than deductible).

d. Employer deduction

Present Law

Employer contributions to a SEP are deductible (1) in the case of a calendar year SEP, for the taxable year with or within which the calendar year ends, and (2) in the case of a SEP maintained on the basis of the taxable year of the employer, for such taxable year. The amount deductible in a taxable year for contributions to a SEP may not exceed 15 percent of the compensation paid to the employees during the calendar year ending with or within the taxable year.

Explanation of Provision

To take into account SEPs that are maintained on the basis of the employer's taxable year, the bill provides that, in the case of such SEPs, the 15 percent of compensation limitation applies to compensation paid during the employer's taxable year.

e. Compensation limit

Present Law

Prior to the Act, the maximum amount of annual compensation that could be taken into account in applying the nondiscrimination rules to a nonelective SEP was $200,000 (sec. 408(k)(3)(C)). As discussed above, the bill clarifies that this limit also applies to elective SEPs. Also, as discussed above, under the Act, this $200,000 limit is to be adjusted for increases in the cost-of-living by the Secretary at the same time and in the same manner as the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)). This Act provision applies to years beginning after December 31, 1986. For 1988, the $200,000 limit has been adjusted to $208,940.

The Act provided that qualified plans may not take into account more than $200,000 of annual compensation. This limit is to be adjusted, beginning in 1990, for post-1988 cost-of-living increases at the same time and in the same manner as the dollar limit on benefits under a defined benefit pension plan. This provision generally applies to benefits accruing in years beginning after December 31, 1988.

Explanation of Provision

Under the bill, the compensation limit for SEPs is conformed to the compensation limit for qualified plans effective for years beginning after December 31, 1988.

B. Nondiscrimination Requirements

1. Minimum coverage requirements (sec. 111(h) of the bill, sec. 1112 of the Reform Act, and sec. 410(b) of the Code)

a. Coverage requirements—general

Present Law

Under present law, a plan is not qualified unless it meets at least one of the following coverage requirements:

(1) the plan benefits at least 70 percent of all nonhighly compensated employees;

(2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or

(3) the plan meets the average benefits test, one requirement of which is that the average benefit percentage for nonhighly compensated employees be at least 70 percent of the average benefit percentage for highly compensated employees.

Under present law, these coverage rules are to apply separately to former employees under rules prescribed by the Secretary.

Explanation of Provision

The bill incorporates in the statute the provision in the Statement of Managers that a plan maintained by an employer that has no nonhighly compensated employees for a year is considered to satisfy the coverage requirements for such year. As is so with respect to the coverage rules generally, this rule is to apply separately with respect to former employees under rules prescribed by the Secretary.

In addition, it is intended that the Secretary is to exercise his authority with respect to the application of the coverage rules to former employees to except, in appropriate cases, retiree benefit increases from the general rule of separate testing.

b. Coverage requirements for collectively bargained plans

Present Law

Under present law, certain special rules apply to a plan maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and 1 or more employers. Under these special rules, the coverage rules (sec. 410 (other than section 410(a))) are to be applied as if all employees of each of the employers who are parties to the collective bargaining agreement and who are subject to the same benefit computation formula under the plan were employed by a single employer (sec. 413(b)(1)). In addition, certain other rules (secs. 401(a)(4) and 411(d)(3)) are to be applied as if all participants who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement were employed by a single employer (sec. 413(b)(2)).

Explanation of Provision

Under the bill, the special rules of section 413(b)(1) (with respect to the coverage rules) and (b)(2) do not apply to a plan that covers any professional employee (e.g., doctor, lawyer, or investment banker). Thus, such plans are to apply sections 401(a)(4), 410 (without regard to section 410(a)), and 411(d)(3) under the general rules otherwise applicable with respect to qualified plans.

c. Definition of elective deferrals

Present Law

Under present law, certain special coverage rules apply to employer contributions to purchase a tax-sheltered annuity contract (sec. 403(b)) under a salary reduction agreement (within the meaning of sec. 3121(a)(5)(D)). The Statement of Managers with respect to the Act provides that an employer contribution is not subject to these special coverage rules (and is instead subject to the general coverage and nondiscrimination rules applicable to qualified plans) if the contribution is made pursuant to a one-time election to participate in the tax-sheltered annuity, even though such contribution would be considered made under a salary reduction agreement under section 3121(a)(5)(D).

Explanation of Provision

The bill conforms the statutory language to the legislative history by providing that contributions to a tax-sheltered annuity are not subject to the special coverage rules (and are instead subject to the general coverage and nondiscrimination rules applicable to qualified plans) if the contributions are made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the annuity or are made pursuant to a similar arrangement specified in regulations.

The bill does not change the definition of salary reduction agreement for purposes of section 3121(a)(5)(D). This amendment also does not affect the definition of elective deferrals other than with respect to tax-sheltered annuities.

2. Minimum participation rule (sec. 111(h) of the bill, sec. 1112 of the Reform Act, and sec. 401(a)(26) of the Code)

Present Law

In general

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer, or (b) 40 percent of all employees of the employer. This requirement may not be satisfied by aggregating comparable plans. Also, this requirement applies on an employer-wide basis and may not be satisfied on a line of business or operating unit basis.

Sanction

If a plan ceases to be qualified because of this minimum participation rule, it is subject to the generally applicable sanctions, one of which is that employer contributions made to the trust during the corresponding taxable year of the employer are includible in employees' incomes under rules applicable to nonqualified arrangements (sec. 83). Under present law, in the case of a plan that fails to be qualified solely because it does not satisfy the coverage requirements (sec. 410(b)), the employee's vested accrued benefit (other than employee contributions), to the extent that such amount has not been previously taxed to the employee, is includible in income, rather than the employer's contribution for the year. Also, nonhighly compensated employees are not taxable on amounts contributed to or earned by the trust merely because a plan fails to satisfy the coverage requirements.

Special transition rule

For purposes of the coverage rules, but not the minimum participation rule, a special transition rule applies in the case of certain dispositions or acquisitions of a business (sec. 410(b)(6)(C)).

Reversion tax and interest rate

The minimum participation rule is generally effective for plan years beginning after December 31, 1988.

Under a special rule, if (1) a plan is in existence on August 16, 1986, (2) the plan would fail to meet the requirements of the minimum participation rule if such rule were in effect on August 16, 1986, and (3) there is no transfer of assets to or liabilities from the plan, or merger or spinoff involving the plan, after August 16, 1986, that has the effect of increasing the amount of assets available for an employer reversion, such plan may be terminated or merged prior to the first plan year to which the minimum participation rule applies and the 10-percent excise tax on the reversion of assets (sec. 4980) will not be imposed on any employer reversion from such plan by reason of such termination or merger. Such a termination and reversion are permissible even though the terminating plan relies on another plan that is not terminated for qualification. In determining the amount of any such employer reversion, the present value of the accrued benefit of any highly compensated employee is to be determined by using an interest rate that is equal to the maximum interest rate that may be used for purposes of calculating a participant's accrued benefit under section 411(a)(11)(B). The Secretary is to prescribe rules preventing avoidance of this interest rate rule through distributions prior to or in lieu of a reversion.

Explanation of Provision

Line of business

Under the bill, the Secretary may permit, under appropriate circumstances, the minimum participation rule to be applied separately to separate lines of business, as defined under section 414(r) without regard to section 414(r)(7). Thus, for this purpose, separate operating units are not considered to be separate lines of business.

In determining whether to permit this separate testing, the Secretary is to consider whether the separate lines of business are related. For example, a football team and a manufacturing business are totally unrelated, so that it may be appropriate to allow separate testing in such circumstances.

Sanction

The bill modifies the sanction applicable to a plan that ceases to be qualified based on a failure to satisfy either the minimum participation rule or the coverage rules. Under the bill, if a plan is not qualified and one of the reasons is the failure to satisfy the minimum participation rule or the coverage rules (either directly or indirectly through the application of sec. 401(a)(4)) , any highly compensated employee is to include in income such employee's vested accrued benefit (other than such employee's investment in the contract). (This modification does not affect the application of the general rules of sec. 402(b)(1) regarding issues other than the amount includible in the year of disqualification, such as the application of sec. 72 to distributions from the disqualified plan.)

In addition, if a plan is not qualified solely because it does not satisfy either the minimum participation rule or the coverage rule (either directly or indirectly through the application of sec. 401(a)(4)) or both, the bill provides that there is to be no inclusion in income by reason of such failure to qualify with respect to any employee who was not a highly compensated employee at any time during the trust year in which the plan became disqualified or during any prior year for which service was creditable to such employee under the plan (or a predecessor plan). For purposes of determining whether an employee was a highly compensated employee in any year, the definition of highly compensated employee applicable with respect to such year for purposes of the coverage rules is to apply.

Except for these changes, the sanctions applicable under present law, including the rules regarding the disallowance of an employer's deduction for contributions to a disqualified plan, continue to apply.

These modifications of the sanctions for disqualification are intended to fulfill the intent of the Act with respect to (1) ensuring that the disqualification sanction is adequate with respect to highly compensated employees, and (2) reducing the sanction with respect to nonhighly compensated employees in appropriate circumstances.

Applicability of affiliated service group and employee leasing rules

In order to prevent avoidance of the minimum participation rule, the bill provides that the affiliated service group rules (sec. 414(m)) and the employee leasing rules (sec. 414(n)) apply for purposes of the minimum participation rule. The bill further clarifies that the Secretary's general regulatory authority to prevent avoidance of certain requirements (sec. 414(o)) applies to the minimum participation rule.

Special transition rule

Under the bill, the special transition rule applicable in the case of certain dispositions or acquisitions of a business (sec. 410(b)(6)(C)) is to apply to the minimum participation rule. This is intended to prevent the minimum participation rule from disrupting business transactions by allowing a grace period following certain transactions for the new entities to comply with the minimum participation rule.

Reversion tax and interest rate

With respect to the rule under present law regarding the exemption from the reversion tax in the case of the termination or merger of certain plans not satisfying the minimum participation rule, the interest rate required to be used in determining the accrued benefit of any highly compensated employee and the corresponding reversion to the employer will in many cases understate the value of the employee's accrued benefit and thus represent an inappropriate reduction in the employee's accrued benefit. In order to avoid this result, the bill modifies the rule referred to above in several respects.

First, the bill clarifies that for purposes of determining the amount to be distributed from a plan to an employee, the value of an employee's accrued benefit is not to be affected by this transitional rule regarding the minimum participation rule. Thus, for this purpose, the accrued benefit is to be determined under the interest rate used by the plan, if otherwise permissible under the Code.

Second, the bill provides a rule regarding the permissible interest rate to be used for certain purposes. The interest rate rule applies in the case of a termination, asset transfer, or asset distribution with respect to a plan that would have failed to satisfy the requirements of the minimum participation rule had the effective date of such rule been August 16, 1986.

If the interest rate rule applies to a plan, the interest rate used in determining an "eligible amount" is to be no less than the highest of:

(1) the rate in effect under the plan on August 16, 1986, or if on August 16, 1986, the rate is determined under a formula (or other method), the rate determined under such formula (or other method);

(2) the highest rate applicable under the plan at any time after August 15, 1986, and before the termination, transfer, or distribution in calculating the present value of the accrued benefit of a nonhighly compensated employee under the plan (or any other plan used in determining whether the plan meets the requirements of sec. 401). For this purpose, if at any time during this period the rate is determined under a formula (or other method), the rate considered to be used during any such period is the rate that would be determined under the formula (or other method) if such formula (or other method) were in effect on the date of termination, transfer, or distribution; or

(3) 5 percent.

For purposes of (1) and (2) above, the rate is to be determined without regard to any amendment adopted after August 16, 1986, even if such amendment is effective retroactively to apply on August 16, 1986. If more than one rate (or formula or method) applies under a plan, such as different rates applying to benefits of different value, the rate applicable under the plan for purposes of (1) and (2) above is the highest of the different rates.

(No inference is intended, based on (2) above, that within a plan (or plans aggregated for purposes of section 410) a higher interest rate may be used in determining the present value of the accrued benefit of a nonhighly compensated employee than is used with respect to any highly compensated employee.)

The term "eligible amount" means the amount that with respect to a highly compensated employee:

(1) may be rolled over under the applicable rules (sec. 402(a)(5));

(2) is eligible for income averaging (sec. 402(e)(1)) or grandfathered capital gains treatment; or

(3) may be transferred to another plan without inclusion in income.

In addition, if an annuity contract purchased after August 16, 1986, is distributed to a highly compensated employee by a plan to which the interest rate rule applies in connection with a termination of or distribution from such plan, the annuity contract is included in the employee's income to the extent of the excess of the purchase price of such contract over the present value of the employee's accrued benefit (or portion thereof) with respect to which the contract is being distributed. For this purpose, the present value of the accrued benefit is to be determined by using the lowest interest rate permitted in determining an eligible amount under the rules described above. The bill also provides that the excess that is includible in income under the above rule is to be disregarded for purposes of the early withdrawal tax (sec. 72(t)) and the excess distribution tax (sec. 4980A).

In the case of a termination of or distribution from a plan to which the interest rate rule applies, the excess (if any) of (1) the amount distributed to a highly compensated employee by reason of the termination or distribution over (2) the amount determined by using the lowest interest rate permitted in determining an eligible amount, also is disregarded for purposes of the early withdrawal tax and the excess distribution tax.

Former employees

It is further intended that for purposes of the minimum participation rule, former employees generally are to be tested separately under rules similar to those applicable for purposes of the coverage rules.

3. Vesting standards (sec. 111(i) of the bill and sec. 1113 of the Reform Act)

Present Law

Under present law, a plan (other than a multiemployer plan) is not qualified unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative schedules. A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Prior to the Act, special vesting rules applied to class-year plans. A class-year plan was a profit-sharing, money purchase, or stock bonus plan that provided for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements were satisfied under prior law if the plan provided that a participant's rights to amounts derived from employer contributions with respect to any plan year were nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

The imposition of the new vesting rules described above, including the repeal of class-year vesting, generally apply to plan years beginning after December 31, 1988, with respect to participants who have at least 1 hour of service after the effective date.

Explanation of Provision

The repeal of class-year vesting was not intended to adversely affect the vesting status of any participant. To fulfill this intent, the bill provides a special rule applicable to plans that after October 22, 1986, used class-year vesting. Whether a plan falls within this category is to be determined without regard to any amendment adopted after October 22, 1986, eliminating class-year vesting.

Plans that fall within the above category are to apply a special rule to any employee that has an hour of service (1) before the adoption of any amendment eliminating class-year vesting, and (2) on or after the first day of the first plan year for which the repeal of class-year vesting is applicable to such employee with respect to the plan. Under this special rule, for the year described in (2) above and any subsequent year, the employee's nonforfeitable right to the employee's accrued benefit derived from employer contributions is to be determined under the class-year vesting schedule that was eliminated if such schedule would yield a larger nonforfeitable right than the new vesting schedule.

4. Application of nondiscrimination rules to integrated plans (sec. 111(g) of the bill, sec. 1111 of the Reform Act, and secs. 401(a)(5) and (1) of the Code)

Present Law

Under present law, a plan is not considered discriminatory merely because contributions or benefits of, or on behalf of, the employees under the plan favor highly compensated employees through permissible integration of the plan. In general, in the case of a defined contribution plan, whether integration is permissible is determined by comparing contributions with respect to compensation above the integration level with contributions with respect to compensation up to the integration level. In the case of a defined benefit excess plan, the rules apply to benefits, rather than contributions, with respect to compensation above and below the integration level.

In the case of a defined benefit excess plan, certain special tests apply if the integration level is above covered compensation. For this purpose, the term "covered compensation" means, with respect to an employee, the average of the taxable wage bases in effect for each year during the 35-year period ending with the year the employee attains age 65, assuming no increase in such wage base for years after the current year and before the employee actually attains age 65.

An integrated defined benefit plan is required to base benefits on average annual compensation.

Explanation of Provision

The bill clarifies that generally it is only employer-provided contributions and benefits that are taken into account in determining whether the contributions or benefits with respect to compensation above and below the integration level satisfy the integration rules.

To fulfill Congressional intent to conform certain qualified plan rules to the social security system, the bill modifies the definition of "covered compensation," so that the references to age 65 are replaced by references to social security retirement age (sec. 415(b)(8)), which can be age 65, 66, or 67, depending on the date of birth of the employee.

The bill also clarifies that "average annual compensation" means the participant's highest average annual compensation for any period of at least 3 consecutive years (or, if shorter, the participant's full period of service). Thus, defined benefit plans providing benefits based on career average compensation are not prevented from integrating.

5. Definitions of highly compensated employee and of line of business (sec. 111(j) and (k) of the bill, secs. 1114 and 1115 of the Reform Act, and sec. 414(q) and (r) of the Code)

Present Law

Highly compensated employee

In general

In general, under present law, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group (generally, the top 20 percent by compensation) during the same year, or (4) was an officer of the employer (generally, as defined in sec. 416(i)). For purposes of this definition, the term "compensation" means compensation as defined under section 415(c)(3) plus certain elective contributions.

Treatment of family members

Present law provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contributions or benefits under the plan on behalf of such family member are aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Even if a family member is excluded for purposes of determining the number of employees in the top-paid group (as discussed below), such family member is subject to the aggregation rule.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees are to be excluded: (1) employees who have not completed 6 months of service; (2) employees who normally work less than 17-1/2 hours per week; (3) employees who normally work not more than 6 months during any year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no United States-source earned income. An example of an instance in which it is appropriate to consider employees covered by a collective bargaining agreement is the case in which the plan being tested is maintained pursuant to a collective bargaining agreement.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business or operating unit rules described below.

Officers

For purposes of the definition of highly compensated employee, no more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees) are to be treated as officers. This same limitation applies for purposes of determining key employees under section 416(i).

Line of business or operating unit rules

Generally, if an employer is treated as operating separate lines of business or operating units for a year, the employer may apply the new coverage rules applicable to qualified plans and the new nondiscrimination rules applicable to statutory employee benefit plans separately to each separate line of business or operating unit for that year.

Under a special rule, a line of business or operating unit will not be treated as separate unless it satisfies certain requirements, one of which is that the line of business or operating unit have at least 50 employees.

In addition, an affiliated service group (within the meaning of sec. 414(m)) may not be treated as consisting of separate lines of business or operating units. Because generally section 414(b) and (c) applies before section 414(m), a group that is treated as aggregated under section 414(b) and (c) is not treated as an affiliated service group even if such group also could have been aggregated under section 414(m).

Explanation of Provision

Highly compensated employees

Indexing

The bill provides that the $50,000 and $75,000 amounts are to be adjusted at the same time and in the same manner as the dollar limit applicable to defined benefit plans (sec. 415(d)). Such adjustments will prevent the definition of "highly compensated employee" from becoming inappropriate by virtue of inflation.

Nonresident aliens

In addition, under the bill, nonresident aliens who receive no United States-source earned income from the employer are to be disregarded for all purposes in determining the identity of the highly compensated employees of the employer. This modification will simplify the application of the rules and will prevent employees who are disregarded for purposes of the nondiscrimination rules from affecting the identity of the highly compensated employees.

Treatment of family members

The bill clarifies the applicability of the special rule for family members of certain highly compensated employees. The rule generally is to be used in applying any provision that refers to the definition of highly compensated employee (e.g., secs. 89, 401(a)(4), 401(a)(5), 401(k), 401(l) (through sec. 401(a)(5)), 401(m), 403(b)(12) (by reference to 401(a)(4), etc.), 408(k), 410(b)). Thus, the special rule does not apply for purposes of, for example, the limits on contributions or benefits (sec. 415) or the $7,000 (indexed) limit on elective deferrals (sec. 402(g)).

In addition, the bill provides the Secretary with regulatory authority to prevent the application of the special family member rule to inappropriate, clearly unintended situations. This regulatory authority is only to be used, however, in a manner consistent with the general policy underlying the family member rule, i.e., that, for purposes of all rules relating to nondiscrimination (or deductibility), the members of the family constitute one economic unit and thus are to be treated as one employee.

For example, assume employees A and B are married and both work for the same employer. A's compensation is $150,000 for the 1990 plan year; she is one of the top 10 highly compensated employees (by compensation). B's compensation is $25,000. Assume further that the employer maintains a money purchase pension plan providing contributions of 10 percent of compensation. The Secretary's regulatory authority could be exercised to prevent the plan from allocating any more than $15,000 to A's account for the 1990 plan year. Thus, the Secretary could preclude the use of compensation paid to one person to be used to provide allocations or accruals to another person.

The bill also clarifies that the special family member rule applies for purposes of the $200,000 limit on the amount of compensation that may be taken into account under a qualified plan (for qualification or deduction purposes) or under an employee benefit plan (secs. 89, 401(a)(17), and 404(l)). (The special family member rule does not apply, however, for purposes of the $200,000 limit that applies under section 416(d), but which was repealed generally for years beginning after December 31, 1988.) However, for this purpose, the definition of a family member is modified to refer only to the employee's spouse and lineal descendants of the employee who do not attain age 19 by the close of the year.

For example, assume that in 1988 employee A of employer X receives compensation (as defined under sec. 414(s)) of $275,000 and is the highly compensated employee with the highest compensation from X. A's spouse (B), adult child (C), and 17-year old child (D) also are employees of X. B, C, and D receive $100,000, $225,000, and $10,000 of compensation (as defined under sec. 414(s)), respectively. X maintains a qualified cash or deferred arrangement (sec. 401(k)) under which A, B, C, and D are eligible. A, B, and C each defers $7,000 under the arrangement; D makes no deferral.

For purposes of applying the special nondiscrimination test applicable to the arrangement (sec. 401(k)(3)), A, B, C, and D are treated as 1 employee. The compensation of this "1 aggregated employee" is determined as follows: A, B, and D are combined and limited to $200,000 (rather than the $385,000 they actually receive). The $200,000 limit applies separately to C because, under the special definition of a family member for purposes of the $200,000 limit, C is not a family member of A, B, or D. Thus, the compensation taken into account for the aggregated employee is $200,000 (for A, B, and D) plus $200,000 (for C) for a total of $400,000. The total deferrals for this aggregated employee are $21,000. Thus, for purposes of applying the special nondiscrimination test to the cash or deferred arrangement, A, B, C, and D are treated as a single employee with a deferral percentage of $21,000/$400,000 or 5.25 percent. Since the family aggregation rule does not apply for purposes of the $7,313 limit ($7,000 indexed for 1988) on elective deferrals (sec. 402(g)), none of the family members is considered to have exceeded such limit.

The bill further clarifies the application of the special family member rule to the integration rules under section 401(l). Although the special family member rule generally applies for purposes of section 401(l), it does not apply in determining the amount of compensation below the plan's integration level except that the total of the compensation below the integration level is subject to the $200,000 limit (sec. 401(a)(17)). Thus, for example, assume the same facts described in the above example, except that instead of maintaining a qualified cash or deferred arrangement, X maintains an integrated, nonelective profit-sharing plan with an integration level of $45,000. Again, the compensation of the aggregated employee is $400,000. Of that $400,000, a total of $145,000 is considered to be below the integration level (i.e., $45,000 each attributable to A, B, and C, and $10,000 attributable to D).

Compensation

Although the definition of compensation used for purposes of determining highly compensated employees under section 414(q) generally is based on the definition used under section 415(c)(3), it is intended that the definitions vary in certain ways. First, it is not intended that, for purposes of section 414(q), compensation be required to be determined on the basis of the plan's limitation year under section 415. Second, it is not intended that employers be permitted to use an employee's accrued compensation for purposes of section 414(q).

Officers

The employees who are excluded for purposes of determining the size of the top-paid group are to be excluded for purposes of determining the 10-percent limit on the number of officers. (As with respect to the top-paid group, the excluded employees may be officers; they are only excluded for purposes of determining the limit on the number of officers.) This limit is to apply for purposes of determining highly compensated employees and key employees (sec. 416).

Line of business or operating unit rules

Under the bill, the Secretary is to prescribe rules providing certain minimum standards regarding the age and service requirements that are to apply for purposes of determining which employees are taken into account in determining if a line of business or operating unit may be treated as separate. (The standards are to apply, for example, for purposes of determining if a line of business or operating unit has 50 employees.) Under this authority, the Secretary could provide that, for such purpose, section 414(q)(8) is to be applied without regard to the last sentence thereof, i.e., the employer may not elect to reduce the age or service requirements specified in the statute.

The primary purpose for this provision of the bill is to prevent the use of nominal age or service requirements to avoid the effect of the requirement that, to be treated as separate, a line of business or operating unit is required to have 50 employees.

6. Definition of compensation (sec. 111(k) of the bill, sec. 1115 of the Reform Act, and sec. 414(s) of the Code)

Present Law

Under present law, except as otherwise provided, "compensation" is defined as compensation for services for an employer that is includible in gross income (sec. 414(s)). The Secretary is to prescribe regulations defining compensation for a self-employed individual based on this definition applicable to common-law employees.

The employer may elect whether to include elective deferrals (under secs. 125, 402(a)(8), 402(h), or 403(b)) as part of compensation. In addition, the Secretary is directed to provide certain alternative definitions of compensation that do not favor highly compensated employees.

An employee who at any time during the plan year or any of the 4 preceding plan years is a 1-percent owner of the employer and has annual compensation from the employer of more than $150,000 is a key employee.

Explanation of Provision

The bill modifies the general definition of compensation so that generally it is the same one used (for employees or self-employed individuals, whichever is applicable) for purposes of the limit on contributions under a defined contribution plan (sec. 415(c)(3)). (The bill does not affect the employer's right to elect to include elective deferrals or the Secretary's authorization to provide alternative definitions of compensation.) This provides greater uniformity, and excludes certain items (such as deductible reimbursements of moving expenses) that were not intended to be taken into account. It is not the intent of the bill, however, to restrict future regulatory modifications of the definition of compensation under section 415(c)(3).

Although the general definition of compensation under section 414(s) is to be the same one used under section 415(c)(3), it is intended that the definitions vary in certain ways. First, it is not intended that, for purposes of section 414(s), the general definition of compensation be required to be determined on the basis of the plan's limitation year under section 415. Second, it is not intended that the general definition of compensation under section 414(s) be an employee's accrued compensation. Third, with respect to defined contribution plans, the general definition of compensation for purposes of section 414(s) is not to include amounts received while an employee is not a participant.

The bill also clarifies that the definition of compensation provided in section 414(s) only applies to provisions that specifically refer to it. Thus, for example, the definition does not apply for purposes of the limits on deductions (sec. 404) or on contributions and benefits (sec. 415).

Under the bill, for purposes of determining whether an employee is a key employee by virtue of having annual compensation over $150,000, compensation means compensation as defined in section 415(c)(3) plus elective deferrals under sections 125, 402(a)(8), 402(h), and 403(b). This is the same definition used for purposes of determining whether an employee is highly compensated (sec. 414(q)(7)), a determination that is similar to the determination of who is a key employee. This provision of the bill applies to years beginning after December 31, 1988.

C. Treatment of Distributions

1. Uniform minimum distribution rules (sec. 111A(a) of the bill, sec. 1121 of the Reform Act, and secs. 402(a)(5), 402(e)(1)(B), and 408(d)(3)(A) of the Code)

Present Law

Under present law, a uniform benefit commencement date and required distribution rules are provided for benefits under all qualified plans (secs. 401(a) and 403(a)), IRAs (sec. 408), tax-sheltered annuities (sec. 403(b)), and eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans).

The Act provided that if an employee is a 5-percent owner at the time a qualified plan distribution is made, such distribution may not be rolled over to a qualified plan or to a section 403(a) annuity plan (sec. 402(a)(5)(F)(ii)). Such prohibition applied to distributions made after October 22, 1986. A different part of the Act repealed this rule for distributions made in years beginning after December 31, 1986. However, the Act did not repeal the provision that prohibited a 5-percent owner from rolling over a qualified plan distribution into a conduit IRA and subsequently rolling the distribution over into another qualified plan.

Explanation of Provision

The bill clarifies that a distribution from a qualified plan and corresponding contribution to an IRA that results in any portion of a distribution being excluded from gross income under the rollover provisions is treated as a rollover distribution for purposes of the IRA rollover provisions.

Also, under the bill, section 402(a)(5)(F)(ii), during the period in which it applied, is not to apply to amounts attributable to benefits accrued before January 1, 1985. Thus, to the extent that a qualified plan distribution to a 5-percent owner is attributable to benefits accrued before January 1, 1985, section 402(a)(5)(F)(ii) during its period of application does not prohibit such distribution from being rolled over to a qualified plan or to an annuity plan.

In addition, the bill deletes the IRA rollover restriction under which certain distributions from IRAs with respect to 5-percent owners are not treated as rollover distributions for purposes of the IRA rules. This provision is effective for rollover distributions made in taxable years beginning after December 31, 1986. Thus, the bill clarifies that, as is the case with other taxpayers, 5-percent owners may roll over a qualified plan distribution into an IRA and subsequently roll the amount distributed from the IRA into another qualified plan. Different rules for 5-percent owners and other taxpayers are no longer necessary under the Act because all distributions from qualified plans are generally subject to the early withdrawal tax formerly applicable only to distributions to 5-percent owners.

Further, the bill provides that, notwithstanding any other provision of law, a plan or contract is permitted (except as provided in regulations prescribed by the Secretary) to incorporate by reference the uniform benefit commencement date and the required distribution rules for qualified plans (sec. 401(a)(9)).

It is further intended that an employee who has not retired from an employer prior to 1989, but has attained age 70-1/2 prior to 1989, is considered to have attained age 70-1/2 in 1989 for purposes of determining the new uniform benefit commencement date with respect to a plan maintained by the employer.

2. Tax treatment of distributions (sec. 111A(b) of the bill, sec. 1122 of the Reform Act, and secs. 72, 402, and 414 of the Code)

The Act generally (1) phased out long-term capital gains treatment over 6 years (except for certain grandfathered individuals); (2) eliminated 10-year forward averaging (except for certain grandfathered individuals) and allowed 5-year forward averaging under more limited circumstances; (3) modified the prior-law basis recovery rules for amounts distributed prior to a participant's annuity starting date; (4) repealed the special 3-year basis recovery rule; (5) modified the general basis recovery rules for distributions from an annuity; (6) provided basis recovery rules for distributions from an IRA when an individual has made nondeductible IRA distributions; (7) repealed the constructive receipt rule for tax-sheltered annuities; and (8) modified the rules relating to rollovers of partial distributions.

a. Basis recovery rules

Present Law

The Act modified the basis recovery rules applicable to distributions from plans to which after-tax employee distributions have been made by (1) eliminating the 3-year basis recovery rule for distributions on or after the annuity starting date, and (2) requiring, with respect to distributions prior to the annuity starting date, that basis be recovered on a pro rata basis.

Further, present law limits the total amount that an employee may exclude from income as a recovery of basis to the total amount of the employee's basis. If benefits cease prior to the date the basis has been fully recovered, the amount of unrecovered basis is allowed as a deduction to the annuitant for his or her last taxable year. These modifications of the basis recovery rules are effective with respect to an individual whose annuity starting date is after July 1, 1986.

Under the Act, employee contributions to a defined contribution plan (and the income attributable thereto) may be treated as a separate contract for purposes of the basis recovery rules.

Under present law, a special basis recovery rule applies with respect to a plan substantially all the contributions to which are employee contributions (sec. 72(e)(7)). Under this special rule, distributions from such a plan are treated first as a return of taxable amounts under the plan.

Explanation of Provision

The bill provides that if employee contributions (and the income attributable thereto) under a defined benefit plan are credited to a separate account that generally is treated as a defined contribution plan (sec. 414(k)), then such separate account is also treated as a defined contribution plan for purposes of the basis recovery rules. The bill clarifies that this separate contract treatment applies without regard to whether the distribution is received as an annuity.

The bill repeals the special basis recovery rules that apply in the case of a plan substantially all of the contributions to which are employee contributions.

The bill clarifies that transfers from one contract (as defined under sec. 72) to another contract are to be treated as consisting of a pro rata amount of income and basis in the same manner as if the transfer had been a distribution prior to the annuity starting date. This rule applies to transfers in any form, such as plan divisions, mergers, etc.

The bill provides that the effective date of the provision allowing a deduction in the last taxable year of the annuitant for unrecovered basis is effective for individuals whose annuity starting date is after July 1, 1986. Thus, in the case of an individual whose annuity starting date is after July 1, 1986, and before January 1, 1987, the rule limiting the amount of basis recovered does not apply, but the rule providing a deduction at death for unrecovered basis does apply. This rule is provided because it would be unfair to deny individuals who lost the benefit of the 3-year basis recovery rule the benefit of the deduction for unrecovered basis at death.

The bill provides a special rule with respect to plans maintained by a State that, on May 5, 1986, provided for withdrawals by the employee of employee contributions (other than as an annuity). In the case of such plans, the modifications in the basis recovery rules for distributions prior to the annuity starting date apply only to the extent that the amount distributed exceeds the employee's basis as of December 31, 1986. In addition, amounts received (other than as an annuity) before or with the first annuity payment are treated as having been recovered before the annuity starting date.

b. Rollovers

Present Law

The Act modified the rules relating to rollovers of partial distributions. Under the Act, partial distributions may be rolled over only if the distribution would satisfy the requirements for a lump-sum distribution and if the distribution is made on account of the death of the employee, the employee's separation from service, or is made after the employee has become disabled. The rule aggregating plans of the same kind applies for purposes of determining whether the amount distributed constitutes 50 percent of the balance to the credit of an employee (sec. 402(e)(4)(C)).

The Act contained a special rule permitting certain amounts deposited in certain financially distressed financial institutions to be rolled over notwithstanding that the rollover does not occur within 60 days of the date of the original distribution. Under this rule, the 60-day period does not include periods while the deposit is frozen. In addition, the individual has a minimum of 10 days after the release of the frozen deposit to complete the rollover.

The Act also provided that distributions from an ESOP made pursuant to the diversification requirements applicable to ESOPs (added by the Act) are treated as partial distributions eligible for rollover treatment.

Explanation of Provision

The bill repeals the provisions of the 1986 Act relating to rollovers of partial distributions, other than the rule permitting distributions made to satisfy the diversification requirements to be rolled over. Thus, under the bill, as under the law prior to the 1986 Act, a partial distribution may be rolled over only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee in the plan (determined immediately before such distribution and without aggregating plans of the same type), (2) with respect to distributions after March 31, 1988, the distribution is not one of a series of periodic payments, and (3) the employee elects rollover treatment (in accordance with regulations). The bill reinstates the pre-1986 Act requirements because the provisions in the Act, particularly the rule aggregating plans of the same type, unduly restricted the situations in which partial distributions could be rolled over. In addition, the bill provides that a partial distribution may be rolled over only if the distribution is made (1) on account of the employee's death, (2) on account of the employee's separation from service, or (3) after the employee has become disabled (within the meaning of sec. 72(m)(7)).

It is intended that, for purposes of the rule denying rollover treatment in the case of a distribution that is part of a series of periodic payments, the mere fact that payments to an employee are made in more than one taxable year does not automatically mean that they constitute a series of periodic payments. For example, it is not uncommon for an employer to make a lump-sum distribution to an employee in one taxable year and discover a calculation error in the following taxable year that requires another distribution to the employee. It is further intended, under these circumstances, that the first distribution is to be treated as a lump-sum distribution (as under present law) and the second distribution is to be treated as a partial distribution eligible for rollover treatment. The partial distribution rollover rules were originally enacted because of employer errors in calculating the lump-sum distributions to which employees are entitled and it is expected that the Secretary's interpretation of the rules will be consistent with this intent.

The bill retains the rule permitting rollover of a distribution made to satisfy the diversification requirements (sec. 401(a)(28)) if an employee elects such treatment and provides that if amounts are rolled over pursuant to these rules an employee is not prohibited from electing income averaging for a subsequent lump-sum distribution.

The bill clarifies that the special rule for frozen deposits applies only to amounts that are frozen within 60 days of the date that the amounts are distributed from the plan.

c. Net unrealized appreciation

Present Law

Under present law, to the extent provided by the Secretary, a taxpayer may elect to waive the special treatment of net unrealized appreciation in employer securities with respect to a lump-sum distribution prior to the time the distribution is received.

Explanation of Provision

Under the bill, the election to waive net unrealized appreciation treatment with respect to a lump-sum distribution is to be made on the tax return on which the distribution is required to be included in gross income if the special treatment is waived. This change is designed to give taxpayers more time to determine whether or not they should make the election. An election to waive the special treatment of net unrealized appreciation does not preclude an election for income averaging.

d. Income averaging and long-term capital gains treatment

Present Law

The Act generally repealed 10-year forward averaging, phased out pre-1974 capital gains treatment over a 6-year period, and made 5-year forward averaging (calculated in the same manner as 10-year averaging under prior law) available for 1 lump-sum distribution with respect to an employee on or after the taxpayer attains age 59-1/2.

In addition, the Act provided a special transition rule under which an individual who had attained age 50 by January 1, 1986, is entitled to make 1 election to use 5-year averaging (under the new tax rates) or 10-year averaging (under the prior-law tax rates) with respect to a single lump-sum distribution. Similarly, such a grandfathered individual could elect capital gains treatment with respect to a lump-sum distribution without regard to the 6-year phaseout of capital gains treatment. Under this special capital gains election, the portion of a lump-sum distribution entitled to capital gains treatment is taxed at a rate of 20 percent, regardless of the maximum effective capital gains rate under prior law.

Under prior law, the amount subject to tax under the income averaging rule was calculated by adding in the zero bracket amount. This addition was eliminated by the Act because the zero bracket amount is eliminated generally.

Explanation of Provision

The bill clarifies that a 5-year averaging election may be made by an individual, trust, or estate for a lump-sum distribution received with respect to an employee who had attained age 59-1/2. In addition, the bill provides that an income averaging election or election of long-term capital gains treatment under the special transition rules may be made by any individual, trust, or estate with respect to an employee who had attained age 50 by January 1, 1986.

The bill also clarifies that, for purposes of 5-year income averaging, the phaseout of the 15-percent bracket applies.

Further, under the bill, the election under the special transition rule of 10-year averaging (under the prior-law tax rates) is to take into account the prior-law zero bracket amount. This change is needed to preserve the prior-law treatment for persons who elect the grandfather rule.

The bill clarifies that a capital gains election made under either of the special transition rules is treated as an income averaging election (within the meaning of sec. 402(e)(4)(B)) for all purposes under the Code (including, for example, sec. 4980A relating to the 15-percent tax on excess distributions).

The bill also provides that a distribution made to satisfy the diversification requirements (sec. 401(a)(28)) will not affect whether a subsequent distribution qualifies as a lump sum distribution eligible for averaging.

3. Additional income tax on early withdrawals (sec. 111A(c) of the bill, sec. 1123 of the Reform Act, and sec. 72 of the Code)

The Act (1) modified the withdrawal restrictions applicable to qualified cash or deferred arrangements, tax-sheltered annuities, and tax-sheltered custodial accounts, and (2) imposed a 10-percent additional income tax on certain early withdrawals from qualified retirement plans.

A qualified retirement plan is defined to include (1) a qualified plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), (3) a tax-sheltered annuity or custodial account (sec. 403(b)), or (4) an individual retirement arrangement (IRA) (sec. 408).

a. Early retirement exception

Present Law

Under the Act, the additional income tax on early withdrawals does not apply to distributions that are made to an employee after separation from service on account of early retirement under the plan after attainment of age 55. This exception does not apply to distributions from an IRA.

In all cases, the exception applies only if the participant has attained age 55 on or before separation from service. Thus, for example, the exception does not apply to a participant who separates from service at age 52 and begins receiving benefits at or after age 55.

Explanation of Provision

The bill modifies the early retirement exception to apply in any case in which an employee receives a distribution on account of separation from service after attainment of age 55, rather than requiring an early retirement under the plan. The intent of this provision is to eliminate what is considered a requirement that has little substantive effect, but could require plan amendment.

The modified early retirement exception continues to apply if the employee returns to work for the same employer (or for a different employer) as long as the employee did, in fact, separate from service before the plan distribution. Of course, any short-term separation is to be closely scrutinized to determine if it is a bona fide, indefinite separation from service that would qualify for this exception to the early withdrawal tax.

As under present law, this exception does not apply to IRA distributions.

b. Exception for distributions from ESOPs

Present Law

Under present law, certain distributions from an employee stock ownership plan (ESOP) are exempt from the additional income tax on early withdrawals. Under the Act, this exception applies to the extent that, on average, a majority of assets in the plan have been invested in employer securities for the 5-plan year period preceding the plan year in which the distribution is made and the exception does not apply to any distribution attributable to assets that have not been invested in employer securities at all times during such 5-plan year period.

Explanation of Provision

The bill modifies the ESOP exception to the additional income tax on early withdrawals to provide that the exception is available to the extent that a distribution from an ESOP is attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(l)) that satisfy the requirements of sections 409 and 401(a)(28) for the 5-plan year period immediately preceding the plan year in which the distribution occurs. Employer securities that are transferred to an ESOP from another plan are also eligible for the exception to the early withdrawal tax as long as the holding period requirement is satisfied with respect to such employer securities taking into account the time such employer securities were held in the other plan.

For example, assume that employer securities that were transferred from a profit-sharing plan are held in an ESOP for the 1-plan year period immediately preceding the plan year in which the distribution is made. If the profit-sharing plan met the requirements of sections 401(a)(28) and 409 with respect to the employer securities for the 4-plan year period immediately prior to the transfer to the ESOP, then the holding period requirement is satisfied. On the other hand, if the profit-sharing plan did not satisfy sections 401(a)(28) and 409 with respect to the transferred securities, the holding period requirement would not be satisfied and the exception to the early withdrawal tax does not apply to the transferred amounts. The bill clarifies that the employer securities are not required to be subject to the requirements of sections 401(a)(28) and 409 prior to the time those requirements are effective (i.e., stock acquired after December 31, 1986, in the case of sec. 401(a)(28)).

These changes are designed to ensure that the ESOP exception only applies with respect to employer securities that are subject to the section 401(a)(28) and section 409 rules applicable to ESOPs.

Under the bill, an ESOP includes both an ESOP described in section 4975(e)(7) and a tax-credit ESOP (within the meaning of sec. 409).

c. Exceptions not applicable to IRAs

Present Law

Under present law, certain exceptions to the additional income tax on early withdrawals are not applicable to distributions from IRAs. These exceptions include the early retirement, medical expense, and ESOP exceptions. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders.

Explanation of Provision

Because the rules relating to qualified domestic relations orders do not apply to IRAs, the bill clarifies that the exception to the early withdrawal tax in the case of distributions pursuant to a qualified domestic relations order does not apply to IRA distributions. This is consistent with the pre-Act law applicable to IRAs.

d. Deferred annuity contracts

Present Law

Under present law, early withdrawals from a deferred annuity contract generally are subject to a 10-percent additional income tax in the same manner as early withdrawals from a qualified plan.

Certain exceptions to the 10-percent early withdrawal tax are provided. An exception is provided for a distribution that is part of a series of substantially equal periodic payments (not less frequently than annually) made over the life or life expectancy of the taxpayer or the lives or life expectancies of the taxpayer and the taxpayer's beneficiary.

If distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the employee changes the distribution method prior to age 59-1/2 to a method that does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied.

In addition, the recapture tax will apply if an employee does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the employee attains age 59-1/2. Thus, for example, if an employee begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59-1/2 as if the exception had not applied. The additional tax will not be imposed on amounts distributed after attainment of age 59-1/2.

The modifications to the additional income tax on early withdrawals under a deferred annuity apply to all distributions made under the annuity in taxable years beginning after December 31, 1986.

Explanation of Provision

The bill clarifies that the substantially equal payment exception and the recapture tax for distributions in violation of the substantially equal payment exception are not limited to distributions to employees under an employer-maintained pension plan. Rather, the exception and recapture tax apply to all distributions under a deferred annuity whether or not received by an individual with respect to the individual's status as an employee.

Further, the bill clarifies that the additional income tax applicable to early withdrawal from a deferred annuity (sec. 72(q)) does not apply if a distribution is otherwise subject to the early withdrawal rules for qualified plans (sec. 72(t)), whether or not an exception to the additional income tax on early withdrawals from a qualified plan applies under section 72(t)(2).

The bill modifies the effective date of the provision relating to the additional income tax on early withdrawals under a deferred annuity so that the changes in the early withdrawal tax do not apply to any distribution under an annuity contract if (1) as of March 1, 1986, payments were being made under such contract pursuant to a written election providing a specific schedule for the distribution of the taxpayer's interest in such contract, and (2) such distribution is made pursuant to such written election.

e. Substantially equal payment exception

Present Law

Under present law, an exception to the 10-percent additional income tax on early withdrawals from a qualified plan or deferred annuity is provided for a distribution that is part of a series of substantially equal periodic payments made (not less frequently than annually) over the life or life expectancy of the taxpayer or the lives or life expectancies of the taxpayer and the taxpayer's beneficiary.

Explanation of Provision

The bill provides that the substantially equal payment exception is available only if the beneficiary whose life or life expectancy is taken into account in determining whether the exception is satisfied is a designated beneficiary of the individual. For this purpose, rules similar to those applicable under section 401(a)(9) are to apply.

f. Qualified voluntary employee contributions

Present Law

Under prior law, an employee who was a participant in a qualified plan, tax-sheltered annuity program, or government plan was allowed a deduction for qualified voluntary employee contributions (QVECs) made by or on behalf of the employee to the plan. The Act repealed the deduction allowed for QVECs, but permitted contributions that had been made prior to repeal to continue to be held under the plan.

Under present law, in addition to the additional income tax on early withdrawals under qualified plans (sec. 72(t)), a 10-percent additional income tax is also imposed on early withdrawals of QVECs (sec. 72(o)).

Explanation of Provision

In order to prevent the imposition of two 10-percent early withdrawal taxes on distributions attributable to QVECs, the bill repeals the 10-percent early withdrawal tax applicable only to QVECs. Thus, distributions from QVECs are treated as distributions from a qualified plan for purposes of the 10-percent additional income tax on early withdrawals and are eligible for any of the applicable exceptions otherwise available for distributions from qualified plans.

g. Tax-sheltered annuities

Present Law

The Act provided that the withdrawal restrictions applicable to tax-sheltered custodial accounts generally were extended to elective deferrals and earnings on elective deferrals under other tax-sheltered annuities. Under these rules, distributions from elective deferrals and earnings on elective deferrals under a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 59-1/2. In addition, withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of the contributions made pursuant to a salary reduction agreement (but not earnings on those contributions).

Under the Act, the provisions restricting distributions attributable to elective deferrals (and earnings thereon) under a tax-sheltered annuity are effective for taxable years beginning after December 31, 1988.

Explanation of Provision

The bill provides that the distribution restrictions added by the Act with respect to tax-sheltered annuities are effective for years beginning after December 31, 1988, but only with respect to distributions from such tax-sheltered annuities that are attributable to assets that were not held as of the close of the last year beginning before January 1, 1989. Thus, the new rules apply to contributions made in years beginning after December 31, 1988, and to earnings on those contributions and on amounts held as of the last year beginning before January 1, 1989.

h. Involuntary cashouts under a qualified plan

Present Law

Under present law, a pension plan may immediately distribute the present value of an employee's benefit under the plan if the employee separates from service with the employer and the present value of the benefit does not exceed $3,500. It was unclear under the Act whether the 10-percent additional income tax on early withdrawals under a qualified plan applies in the case of such involuntary cashouts of benefits.

Explanation of Provision

The bill clarifies that the additional income tax on early withdrawals under a qualified plan is to apply in the case of an involuntary cashout under section 411(a)(11) or 417(e). Of course, the early withdrawal tax does not apply if the amount of the benefit paid to an employee is rolled over to another qualified plan or an IRA.

4. Transition rule (sec. 111A(d) of the bill and sec. 1124 of the Reform Act)

Present Law

Under the Act, a special transition rule was provided in the case of employees who separated from service during 1986. In the case of such an employee, if the employee received a lump-sum distribution before March 16, 1987, on account of the separation from service, then the employee could treat the lump-sum distribution as received in 1986 for all purposes. Thus, the lump-sum distribution is includible in income in 1986 and, assuming the employee is otherwise eligible, the employee can elect 10-year income averaging with respect to the lump-sum distribution.

Explanation of Provision

Under the bill, the special transition rule is amended to apply in the case of an employee who dies, separates from service, or becomes disabled at any time before 1987, including years prior to 1986. In the case of such an employee, if an individual, trust, or estate receives a lump-sum distribution with respect to the employee after December 31, 1986, and before March 16, 1987, on account of the employee's death, separation from service, or disability, then the individual, trust, or estate may treat the distribution as if it was received in 1986 for all purposes under the Code. This restructuring of the rule is intended to make it clear that (1) an individual, trust, or estate may elect the transition rule with respect to a lump-sum distribution received for an employee who otherwise would qualify for the transition rule and (2) a separation from service on account of death or disability is also a separation from service for purposes of the transition rule.

The bill also clarifies that, for purposes of the transition rule, the 5-years-of-participation requirement (sec. 402(e)(4)(H)) and the election requirement (sec. 402(e)(4)(B)) applicable to lump-sum distributions do not apply.

5. Loans from qualified plans (sec. 111A(h) of the bill, sec. 1134 of the Reform Act, and sec. 72(p) of the Code)

Present Law

Under present law, an individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) if certain requirements are satisfied.

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits under present law.

Present law provides for the disallowance of the deduction for interest paid on a loan from a qualified plan by (1) all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account, and (2) key employees with respect to loans from any qualified plan or tax-sheltered annuity or custodial account.

Explanation of Provision

Present law does not expressly prescribe the period during which the interest deduction disallowance rule applies. Therefore, the bill clarifies the period during which the interest deduction disallowance rule applies to include the period (1) on or after the first day on which the individual to whom a loan is made is a key employee or (2) the loan is secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account.

D. Limits on Tax Deferral Under Qualified Plans

1. Overall limits on contributions and benefits under qualified plans (sec. 111(d) of the bill, sec. 1106 of the Reform Act, and secs. 404 and 415 of the Code)

The Act revised the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs. In addition, the Act (1) provides special rules with respect to plans of governmental employers and tax-exempt employers, (2) permitted a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary retirement benefit under the plan, (3) imposed a limit on the amount of compensation that may be taken into account for deduction purposes, and (4) modified the rules relating to the phasein of the limits on annual benefits under a defined benefit pension plan.

a. Includible compensation

Present Law

Under present law, not more than $200,000 of compensation of an employee may be taken into account under a qualified plan. This $200,000 limit on includible compensation applies for most purposes under the Code, including the provisions relating to nondiscrimination requirements and to deductibility. Consequently, no more than $200,000 of an employee's compensation for a year may be taken into account in computing deductions for plan contributions.

This $200,000 limit is to be adjusted, beginning in 1990, for post-1988 cost-of-living increases at the time and in the manner provided for the adjustment of the limits on annual benefits under a qualified defined benefit pension plan (sec. 415(d)).

Explanation of Provision

Under the bill, increases in the $200,000 limit on includible compensation may not be taken into account before they occur in determining the deduction limit for contributions to a qualified plan. Similarly, such increases may not be taken into account before they occur in calculating the full funding limitation (as determined under sec. 412).

Further, the bill makes it clear that the $200,000 cap on includible compensation does not apply, under present law, in the case of an employer's deduction for benefits provided under a nonqualified deferred compensation plan.

b. Eligibility to receive maximum benefits

Present Law

Under the Act, a reduced dollar limit applies to participants who have completed fewer than 10 years of participation in a defined benefit pension plan (sec. 415(b)(5)). With respect to such participants, the dollar limit is determined by multiplying the otherwise applicable dollar limit by a fraction. The numerator of the fraction is the number of years (including a fractional year) of participation in the plan completed by the employee. The denominator of the fraction is 10.

The Act provides that, to the extent provided in regulations, the reduction based on years of participation is to be applied separately with respect to each change in the benefit structure of a plan by a plan amendment or otherwise as if such change is a new plan. Such regulations are to take into account whether the change is a benefit improvement or reduction. The phasein for each change in benefit structure begins on the date a plan amendment creating the change is effective.

A separate phase-in rule applies to the 100-percent of compensation limit (sec. 415(b)(1)(B)) and to the $10,000 limit on de minimis benefits (sec. 415(b)(4)). Under this rule, those limits are phased in on the basis of years of service rather than years of participation.

Explanation of Provision

The bill clarifies that the rule requiring separate phaseins for each change in benefit structure under a plan does not apply in the case of the phasein of the 100 percent of compensation limit or the $10,000 limit on de minimis benefits.

The bill further provides that, for purposes of the combined limit on contributions and benefits (sec. 415(e)), the dollar limit on benefits under a defined benefit pension plan is to be phased in over 10 years of service, rather than 10 years of participation. Correspondingly, the rule requiring a separate phasein for each change in benefit structure does not apply for purposes of the combined limit.

c. Qualified cost-of-living arrangements

Present Law

In general

The Act permitted a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. If the arrangement is qualified, then an employee contribution under the arrangement is not to be treated as an annual addition in applying the separate limit on annual additions under defined contribution plans (sec. 415(c)), but is to be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Further, under a qualified arrangement, the benefit attributable to an employee's contribution is to be treated as a benefit derived from employer contributions for purposes of applying the limit on annual benefits (sec. 415(b)). Under the Act, a qualified cost-of-living arrangement is required to comply with the dollar limits, election procedures, and nondiscrimination requirements of the Act.

Limit requirement

A qualified cost-of-living arrangement satisfies the limit requirement provided by the Act if it (1) limits cost-of-living adjustments to those cost-of-living increases occurring after the annuity starting date, and (2) bases the cost-of-living adjustment on average cost-of-living increases determined by reference to 1 or more indices prescribed by the Secretary, except that the plan can provide a minimum increase for each year of 3 percent of the original retirement benefit. It was unclear, under the Act, whether a plan could provide for a minimum increase for each year of 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.

Election requirement

A qualified cost-of-living arrangement meets the election requirements if it provides that participation in the qualified cost-of-living arrangement is elective and permits participants to make an election in (1) the year in which the participant attains the age at which retirement benefits are first available under the defined benefit pension plan; (2) the year in which the participant separates from service; or (3) both such years.

Explanation of Provision

Limit requirement

The bill clarifies that a plan will not fail to satisfy the limit requirement if it provides for a minimum increase for each year of 3 percent of the retirement benefit (determined without regard to the current year's increase). Thus, the minimum increase may be 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.

Election requirement

Under the bill, a plan may permit participants to make an election under the qualified cost-of-living arrangement during any year, as long as the plan permits elections to be made at least in the year in which the participant (1) attains the earliest retirement age under the defined benefit pension plan (determined without regard to any requirement of separation from service), or (2) separates from service.

d. Computation of combined limit

Present Law

Under a transition rule of the Act, in the case of a plan that satisfied the requirements of the overall limits on contributions and benefits (sec. 415) for its last year beginning before January 1, 1987, Treasury regulations are to provide for the determination of an amount that is to be subtracted from the numerator of the defined contribution fraction so that the sum of the defined benefit plan fraction and the defined contribution plan fraction (sec. 415(e)(1)) does not exceed 1.0 for such year. This amount to be subtracted is not to exceed the numerator of the fraction.

Explanation of Provision

The bill clarifies that the adjustment to the sum of the defined benefit plan fraction and the defined contribution fraction so that such sum does not exceed 1.0 for purposes of this transition rule is determined as if the new rules were in effect for the last year beginning before January 1, 1987.

2. Deduction limits for qualified plans (sec. 111A(e) of the bill, sec. 1131 of the Reform Act, and sec. 4972 of the Code)

Present Law

In general

Under present law, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan (secs. 401(a) and 403(a)) or simplified employee pension (SEP) (sec. 408(k)).

Amount of nondeductible contributions

The contributions to a plan that are subject to the excise tax on nondeductible contributions are (1) the amounts contributed to a qualified employer plan by the employer for the taxable year in excess of the amount allowable as a deduction for the taxable year, plus (2) the unapplied amounts in the preceding taxable year. The unapplied amounts in the preceding taxable year are the amounts subject to the excise tax in the preceding year reduced by the sum of (1) the portion of the amounts that are returned to the employer during the taxable year, and (2) the portion of such unapplied amounts that are deductible during the current taxable year.

Time for determination of nondeductible contributions

Nondeductible contributions for a year are determined as of the close of the employer's taxable year. A contribution made on account of a year that is made after the close of the year is to be taken into account in determining the level of excess contributions for the year with respect to which the contribution is made.

Nondeductible contributions to underfunded plans

Under the Act, the excise tax on nondeductible contributions applies to nondeductible contributions to underfunded plans.

Definition of employer

The excise tax on nondeductible contributions is imposed on the employer. Under present law, in the case of a plan that provides contributions or benefits for employees some or all of whom are self-employed individuals (sec. 401(c)(1)), an individual who owns the entire interest in an unincorporated trade or business is treated as the employer. Also, under present law, a partnership is to be treated as the employer of each partner who is considered to be an employee (sec. 401(c)(1)).

Under the Act, an employer to whom the excise tax on nondeductible contributions applies includes an employer that is a tax-exempt organization.

Combinations of pension and other plans

Under present law, if an employer contributes to 1 or more qualified defined contribution plans (i.e., 1 or more qualified money purchase pension plans, profit-sharing plans, or stock bonus plans) and 1 or more qualified defined benefit pension plans for a taxable year, then the amount deductible in that taxable year (under sec. 404(a)(7)) is not to exceed the greater of (1) 25 percent of the compensation otherwise paid or accrued during the taxable year to the employees who benefit under the plans, or (2) the amount of contributions made to or under the defined benefit pension plan or plans to the extent necessary to meet the minimum funding standard for that plan (sec. 412).

Present law coordinates the deduction limits for employer contributions to a simplified employee pension (SEP) with the deduction limit applicable to profit-sharing or stock bonus plans.

Explanation of Provision

Amount of nondeductible contributions

Under the bill, the definition of nondeductible contributions includes, for purposes of the excise tax, contributions allocable to the purchase of life, accident, health, or other insurance on behalf of a self-employed individual, but only to the extent that the contributions would be nondeductible without regard to the special rule limiting deductions for such contributions (sec. 404(e)).

The bill clarifies that the amount allowable as a deduction (without regard to sec. 404(e)) for any taxable year is treated as coming first from carryforwards to the taxable year from preceding taxable years (in order of time) and then from employer contributions made during the taxable year.

Further, under the bill, the unapplied amounts in the preceding taxable year do not include nondeductible contributions made for years prior to the effective date of the excise tax on nondeductible contributions. However, carryforwards from pre-effective date years are applied first against the deduction limit (without regard to sec. 404(e)) in determining whether contributions after the effective date are subject to the excise tax.

Time for determination of nondeductible contributions

Because the determination of nondeductible contributions as of the end of a taxable year includes contributions made after the close of the taxable year with respect to the year, the bill provides that contributions that are returned (together with the income allocable thereto) to an employer (to the extent permitted under sec. 401(a)(2)) by the due date of plan contributions for the year (sec. 404(a)(6)) are not treated as nondeductible contributions subject to the excise tax.

Nondeductible contributions to underfunded plans

Under the bill, the excise tax on nondeductible contributions does not apply in the case of a plan that is underfunded and to which Title IV of ERISA applies. A plan is underfunded if, as of the close of the plan year with or within which the taxable year begins, (1) the liabilities of the plan (determined as if the plan were terminated on that date) exceed (2) the assets of the plan. In the case of such an underfunded plan, contributions for a plan year up to the excess calculated under the preceding sentence are not subject to the excise tax even if such contributions are not deductible by the employer. This provision does not apply to years beginning after December 31, 1987. In such years, section 404(a)(1)(D), added by the Omnibus Budget Reconciliation Act of 1987, generally permits certain employers to deduct contributions to defined benefit pension plans that raise the level of plan assets up to current liability.

Definition of employer

The bill provides that the excise tax on nondeductible contributions does not apply in the case of an employer that has been exempt from income tax at all times. Under rules to be prescribed by the Secretary, this exception does not apply to the extent that the employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.

The original rationale for the excise tax was that, by making nondeductible contributions to qualified plans, often the benefit of tax-free growth on the amounts contributed outweighed the delay in the employer's deduction for plan contributions. Such an incentive to make nondeductible contributions increased the likelihood that employers would use qualified plans as a tax-favored savings vehicle, particularly in the case of small plans that primarily benefit the owners of the employer. The excise tax on reversions may not offset the value of the deferral of tax on earnings on nondeductible contributions to qualified plans.

Such a rationale does not apply in the case of contributions to plans maintained by governments or tax-exempt organizations. In the case of such plans, the employer generally has no incentive to make plan contributions solely to receive the benefit of tax-free growth because the employer could hold the funds directly without incurring current income tax. Thus, an incentive to use a qualified plan as a tax-favored savings vehicle generally does not exist in the case of a qualified plan maintained by a government or tax-exempt employer.

Combinations of pension and other plans

The bill clarifies that the limit on an employer's deduction for contributions to a combination of qualified plans (sec. 404(a)(7)) also applies in the case of (1) a combination of a profit-sharing or stock bonus plan and a money purchase pension plan or an annuity plan (sec. 404(a)(2)), and (2) a money purchase pension plan and an annuity plan. In addition, for purposes of section 404(a)(7), the bill treats a simplified employee pension (SEP) as a separate profit-sharing or stock bonus plan. Thus, a combination of a SEP and certain qualified plans is subject to section 404(a)(7).

Effective date

The bill provides a delayed effective date for the changes in the deduction rules for plans maintained pursuant to a collective bargaining agreement (see the discussion in Part E, below).

3. Excise tax on reversion of qualified plan assets to employer (sec. 111A(f) of the bill, sec. 1132 of the Reform Act, and sec. 4980 of the Code)

Present Law

In general

Under present law, a 10-percent excise tax is imposed on a reversion from a qualified plan. The excise tax is imposed on the employer maintaining the plan.

Present law defines a reversion as the amount of cash and the fair market value of other property received (directly or indirectly) by an employer from a qualified plan. No inference is to be drawn from the definition of a reversion as to the income tax consequences and the effect on a plan's qualified status of a transfer of assets from a qualified plan that has not been terminated to another qualified plan.

Special rule for assets transferred to ESOPs

Present law provides an exception to the excise tax on reversions in the case of asset reversions that are transferred from a qualified plan to an employee stock ownership plan (ESOP). The amount transferred is not includible in the income of the employer, nor is the amount transferred deductible by the employer as a plan contribution. No inference is to be drawn from this exception as to the circumstances in which asset transfers will or will not satisfy the exclusive benefit rule and any other applicable qualification requirements (e.g., sec. 401(a)(2) and 414(l)).

Under present law, the amount transferred to the ESOP is required to be used, within 90 days after the transfer, to acquire employer securities (as defined in sec. 409(l)) or to repay a loan the proceeds of which are or were used to acquire employer securities.

Employer securities acquired with the amounts transferred are to be allocated immediately under the plan to ESOP participants, subject to the limits under section 415. As provided under the plan, the amount transferred but not allocated in the year of transfer (by reason of the limitation of sec. 415) may be held in a suspense account pending allocation (provided allocations of the amounts in the suspense account are made no more slowly than ratably over a 7-year period).

The employer securities acquired with the transferred assets are to be held under the plan until distributed to plan participants.

The special exception for transfers to an ESOP does not apply to transfers occurring on or after January 1, 1989, unless the transfer occurs on account of a plan termination before January 1, 1989.

Explanation of Provision

The bill clarifies that the exception to the excise tax on reversions in the case of transfers of assets to an ESOP applies to transfers to tax-credit ESOPs (sec. 409) as well as ESOPs described in section 4975(e)(7). Absent this clarification, a tax-credit ESOP would be required, in order to qualify for the ESOP exception, to add plan language applicable to leveraged ESOPs even if the ESOP did not have any outstanding loans.

The bill provides an exception to the rule that the employer securities acquired with transferred assets are to be held under the plan until distributed to plan participants. Under this exception, the transferred amounts are not required to be held in employer securities if a plan participant elects to diversify a portion of the participant's account balance (under the rules of sec. 401(a)(28)) that includes such employer securities and diversification cannot be accomplished through the use of nontransferred assets.

The bill also clarifies that amounts attributable to the employer securities acquired with the transferred assets are also subject to the requirements that (1) such amounts, within 90 days, be invested in employer securities (as defined in sec. 409(l)) or used to repay loans used to acquire such securities, and (2) subject to the exception discussed above, such employer securities remain in the plan until distribution to participants in accordance with the provisions of the plan.

In addition, the bill provides that, with respect to the allocation of employer securities acquired with transferred amounts (and amounts attributable thereto), the minimum amount required to be allocated to participants' accounts in the ESOP in the year in which the transfer occurs is not to be less than the lesser of (1) the maximum amount that could be allocated without violating the requirements of section 415, or (2) 1/8 of the shares acquired with the amounts transferred (and amounts attributable to such amounts). Thus, the requirement in the Act that stock acquired with amounts transferred to an ESOP is required to be allocated in the year of transfer up to the maximum amount permitted to be allocated under the limits on contributions (sec. 415) is repealed.

If employer securities are held in a suspense account pending allocation under the foregoing rule, the bill clarifies that dividends on such securities are to be (1) allocated to the accounts of participants and beneficiaries in proportion to their account balances, (2) paid to participants and beneficiaries in proportion to their account balances, or (3) used to repay any loans the proceeds of which were used to purchase employer securities.

The bill clarifies the exception for transfers to ESOPs to the general rule that the employer is required to include the amount of any reversion in income. Under the bill, the exception to the income inclusion requirement applies to any reversion occurring after March 31, 1985, if the reversion is transferred to an ESOP, subject to the January 1, 1989, termination of the ESOP exception.

Finally, the bill clarifies, by statute, that an employer is not entitled to any deduction or credit for any amount transferred to an ESOP to the extent that the special exception to the reversion tax applies to the transfer. This rule is added to prevent an employer from gaining a double tax benefit (i.e., granting a deduction or credit for previously deductible contributions) by transferring assets to an ESOP.

4. Excise tax on excess distributions from qualified retirement plans (sec. 111A(g) of the bill, sec. 1133 of the Reform Act, and sec. 4980A of the Code)

Under the Act, an excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. To the extent that aggregate annual distributions paid to a participant from such tax-favored retirement arrangements are excess distributions, the Act generally imposes an excise tax equal to 15 percent of the excess. The excise tax will be reduced by the amount of tax on the distribution under the provision applying a 10-percent additional income tax on early withdrawals (sec. 72(t)).

a. Definition of excess distributions

Present Law

Under the Act, excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed $112,500, indexed at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan. For 1988, the indexed amount is $117,529.

The Act provided a special elective grandfather rule with respect to benefits accrued as of August 1, 1986. If this grandfather rule is not elected, then the definition of excess distributions is the greater of (1) $112,500 (indexed) or (2) $150,000.

Explanation of Provision

The operation of the grandfather provision of the Act in effect overrode the general definition of excess distributions in the Act. Thus, the general definition of excess distributions is the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of (1) $112,500 (indexed) or (2) $150,000. The bill restructures the provision to make the general rule clear.

b. Distributions subject to the tax

Present Law

In determining the amount of retirement distributions that are subject to the excise tax, aggregate annual distributions made with respect to an individual from all pension, profit-sharing, stock bonus, and annuity plans, IRAs, and tax-sheltered annuities generally are taken into account, regardless of the form of the distribution or the number of recipients.

Under the Act, however, certain amounts are excluded in determining such aggregate annual distributions. Excludable distributions include (1) amounts representing a return of an employee's after-tax contributions (but not earnings thereon) or other amounts that are treated as part of the employee's investment in the contract, (2) amounts excluded from the recipient's income because they are rolled over into another plan or an IRA, and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income.

Explanation of Provision

The bill clarifies that the exception to the amounts taken into account in determining aggregate annual distributions under a plan for investment in the contract is not limited to an employee's investment in the contract under a qualified plan, but also includes an individual's investment in the contract under an IRA. The Act was not intended to limit the exception for investment in the contract to amounts received by employees in their capacity as such.

In addition, the bill provides that, in the case of an annuity contract that is distributed to an individual and not included in the individual's income when the contract is distributed, the distribution of the contract is disregarded in applying this excise tax. Rather, payments made under or received for such an annuity contract are treated as retirement distributions subject to the excise tax to the extent they are excess distributions.

In order to identify only those qualified plan distributions that represent a payment of a benefit under the plan, the bill provides that certain amounts returned to an employee under a qualified cash or deferred arrangement or a plan subject to the special nondiscrimination requirements for employee contributions and employer matching contributions are not treated as part of the aggregate annual distributions under a plan. Thus, under the bill, aggregate annual distributions do not include a distribution, with respect to an individual, of excess deferrals (as defined in sec. 402(g)) (and income allocable thereto), excess contributions (as defined in sec. 401(k)(8)) (and income allocable thereto), excess aggregate contributions (as defined in sec. 401(m)(6)) (and income allocable thereto), or certain amounts withdrawn from an IRA before the due date of the return (sec. 408(d)(4)).

Under the bill, the operation of community property laws is disregarded in determining the amount of aggregate annual distributions subject to the excise tax. Thus, just as a nonemployee spouse's interest in an employee spouse's pension benefit is not taken into account in determining the taxable income of an employee upon distribution from or under a qualified plan, a nonemployee spouse's interest in such distributions is also disregarded in determining aggregate annual retirement distributions subject to the excise tax.

c. Grandfather rule

Present Law

Under the Act, certain individuals may elect to be covered by a special grandfather rule that exempts from the excise tax benefits accrued as of August 1, 1986 (including benefits accrued under any arrangements distributions from which are subject to the tax). Under the grandfather, in the case of a defined contribution plan or IRA, the accrued benefit of a participant as of August 1, 1986, is the participant's accrued benefit on that date. In the case of a defined benefit pension plan, the accrued benefit as of August 1, 1986, is the present value of the participant's benefit under the plan, determined as if the participant separated from service on that date. Benefits accrued as of August 1, 1986, to which the participant does not have a nonforfeitable right are included in the definition of accrued benefits for purposes of the grandfather rule.

If the grandfather rule is elected, then, for all purposes, the threshold for retirement distributions that are excess distributions is $112,500 (indexed), rather than the greater of $112,500 (indexed) or $150,000.

The election to use the grandfather rule is to be made on a return for a year beginning no later than January 1, 1988, and is to be made in such form and contain such information as the Secretary may prescribe. The election, once made, applies generally to all retirement distributions made with respect to an individual, including amounts subject to the special estate-level tax after the individual's death. In addition, if an individual dies before the end of the election period, the executor of the individual's estate may make the grandfather election.

The grandfather rule may only be elected with respect to an individual if, as of August 1, 1986, the present value of the individual's interests subject to the excess distribution tax (if such tax were in effect on that date) exceeds $562,500.

Explanation of Provision

Under the bill, for purposes of the grandfather rule, benefits accrued as of August 1, 1986, do not include amounts that, as of August 1, 1986, would not be distributions subject to the excise tax (if the tax were in effect on August 1, 1986) if distributed on that date. Thus, under the bill, an individual's accrued benefit, for purposes of the grandfather, does not include any portion of the accrued benefit that, as of August 1, 1986, (1) is payable to an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)) if includible in the income of the alternate payee, or (2) is attributable to the individual's investment in the contract.

The bill clarifies that the grandfather rule is available if amounts are received with respect to an individual under (1) the general rule applicable to lifetime distributions, (2) the special rule for lump-sum distributions, or (3) the special estate tax rule discussed below. Further, the bill provides that an election may be made with respect to the grandfather treatment either on an income or estate tax return of the individual.

d. Post-death distributions

Present Law

The Act provided special rules to calculate the extent to which retirement distributions made with respect to an individual after the individual's death are excess distributions subject to the excise tax. In lieu of subjecting the post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, the Act added an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. After the estate tax is imposed, post-death distributions are disregarded entirely in applying the excise tax on excess distributions. Thus, beneficiaries who are receiving distributions (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retirement plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value of annual payments equal to the annual excess distribution ceiling for a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all qualified plans, tax-sheltered annuities, and IRAs will be taken into account regardless of the number of beneficiaries.

Explanation of Provision

The bill clarifies that, as under the general rule, the amount of the excess retirement accumulation with respect to an individual for purposes of the special estate tax is determined without regard to community property laws. This rule is provided so that the treatment of post-death distributions is consistent with the treatment of distributions made with respect to an individual prior to death.

In addition, under the bill, benefits that represent the decedent's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are disregarded in determining the excess retirement accumulation.

The bill redefines the excess retirement accumulation to be the excess (if any) of the present value of the decedent's interests in all qualified retirement plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value (as determined under rules prescribed by the Secretary as of the applicable valuation date) of a single life annuity with annual payments equal to the annual excess distribution limit (as in effect for the year in which death occurs and as if the individual had not died). The bill provides that a decedent's interest in a plan or arrangement subject to the excess distribution tax generally does not include the decedent's interest as a beneficiary in a plan or arrangement for purposes of determining the excess retirement accumulation (other than a spousal beneficiary who makes the special election described below).

Under the bill, the excess retirement accumulation with respect to an individual does not include amounts that are death benefits payable with respect to such individual. Therefore, the bill provides that the excess retirement accumulation does not include the value of any death benefits payable by the plan immediately after death with respect to a decedent to the extent that the sum of such death benefits plus other benefits payable with respect to the decedent exceeds the total value of benefits payable with respect to the decedent immediately prior to death.

The bill clarifies that, with respect to this special estate-level tax, the tax may not be offset by any credits against the estate tax (such as the unified credit).

Further, the bill provides an exception to the general rule that the special estate-level tax applies to all excess retirement accumulations with respect to an individual and that, after the estate-level tax is imposed, a beneficiary receiving distributions with respect to the individual is not required to aggregate the amounts received with any other retirement distributions received by the beneficiary on the beneficiary's own behalf. Under this exception, if the spouse of an individual is the beneficiary of all retirement accumulations with respect to the individual, the spouse may elect, on a form attached to the estate tax return, (1) not to have the special estate-level tax apply and (2) for purposes of the general rule, to have the distributions received with respect to the individual aggregated with any distributions that the spouse receives on the spouse's own behalf. Thus, the amounts received with respect to the individual would be subject to the general excise tax on excess distributions to the extent that the amounts, when aggregated with the spouse's own benefits from or under qualified plans, tax-sheltered annuities, and IRAs, exceed the threshold for the excise tax. Because the spouse is treated as a participant, rather than as a beneficiary, if the election is made, the special rule that disregards a decedent's interests as a beneficiary in a plan or arrangement does not apply in determining the spouse's excess retirement accumulation.

For purposes of this exception to the estate-level tax, if 1 or more persons other than the spouse are beneficiaries of a de minimis portion of the interests with respect to the individual that otherwise would be subject to the estate-level tax, then the spouse is not treated as failing to receive all excess retirement accumulations with respect to the individual. Further, such de minimis amounts are not subject to the excise tax on excess distributions with respect to the decedent nor to the special estate-level tax if the spouse makes the election described above. For purposes of this rule, an amount will not be considered de minimis if it exceeds 1 percent of the decedent's retirement accumulation.

The bill clarifies that the special estate tax on a decedent's excess retirement accumulation is not deductible against income in respect of the decedent (sec. 691). Rather, the bill provides that a deduction is allowed from the gross estate of the decedent for the special estate tax.

Under the bill, an executor of a decedent's estate is required to file an estate tax return if the special tax on excess retirement accumulations applies and without regard to whether a return would otherwise be required to be filed.

e. Effective date

Present Law

Under the Act, the provisions generally apply to distributions made after December 31, 1986. The special estate-level tax applies with respect to the estate of a decedent dying after December 31, 1986.

Explanation of Provision

The bill clarifies that the provisions do not apply to distributions with respect to a decedent who dies before January 1, 1987.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary contribution plans (sec. 111A(j) of the bill, sec. 1136 of the Reform Act, and sec. 401(a)(27) of the Code)

Present Law

Under present law, employer contributions to a profit-sharing plan are not limited to the employer's current or accumulated profits. Contributions to a money purchase pension plan are required to be fixed without reference to profits.

Explanation of Provision

Under the bill, in the case of a plan that is intended to be a money purchase pension plan or a profit-sharing plan, a trust forming part of such plan will not be qualified unless the plan designates such intent at such time and in such manner as the Secretary may prescribe. Of course, a plan amendment is not required to comply with this rule until such time as plan amendments generally are required under the Act (Act sec. 1140). Prior to such time, the Secretary may require designation in a different manner.

2. Time required for plan amendments (sec. 111A(l) of the bill and sec. 1140 of the Reform Act)

Present Law

The Act generally allowed plans that operated in compliance with the new requirements of Title XI of the Act to delay the corresponding plan amendments to a specified time.

Explanation of Provision

The bill provides the same delayed amendment rules (other than those relating to a model amendment to be prescribed by the Internal Revenue Service) with respect to the plan amendments required by Title XVIII of the Act (the technical corrections title) or by the bill itself. This furthers the intent of Congress to ease the administrative burdens on plans by delaying the date required for certain amendments so that, in general, all required amendments can be made in a single year.

In addition, the bill provides that a collective bargaining agreement is not to be treated as terminated merely because a plan is amended pursuant to the agreement to meet the requirements of Title XI or Title XVIII of the Act. The bill does not intend to create an inference that such an amendment otherwise would be considered a termination, or that an amendment made solely to conform a plan to a requirement added by another Act is considered a termination.

3. Federal Thrift Savings Plan (sec. 111A(n) of the bill, sec. 1147 of the Reform Act, and secs. 3121(v) and 7701(j) of the Code)

Present Law

Beginning in 1987, an employee generally is permitted to contribute up to 10 percent of the employee's rate of basic pay to the Thrift Savings Plan maintained by the Federal Government. If the limitation on elective deferrals is not exceeded, contributions to the plan are not treated as made available merely because the employee had an election to receive the amounts in cash. Therefore, the amounts deferred are not includible in an employee's income until distributed.

Explanation of Provision

The bill clarifies that the Thrift Savings Plan is required to meet the rules of section 401(k)(4)(B) under which the Plan may not be maintained by any State or local government or any tax-exempt organization.

4. Effective dates for collectively bargained plans (secs. 111 (c), (g), (h), and (n), and 111A(e) of the bill, and secs. 1105, 1111, 1112, 1120, and 1131 of the Reform Act)

Present Law

Under the Act, the effective dates of certain provisions are delayed with respect to plans maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986 ("collectively bargained plans"). In some cases, the delayed effective date applies to the entire plan and, in other cases, the delay only applies to, for example, individuals covered by 1 or more of the collective bargaining agreements.

The provisions subject to the delayed effective date generally do not apply to years beginning before the earlier of—

(1) the later of (a) January 1, 1989 (or, in certain cases, January 1, 1987) or (b) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991 (or, in certain cases, January 1, 1989).

Explanation of Provision

The bill generally provides that the delayed effective date with respect to collectively bargained plans applies to the entire plan in the case of the amendments made by sections 1111 (relating to the application of nondiscrimination rules to integrated plans) and 1112 (relating to the minimum coverage and participation requirements for qualified plans) of the Act. As under present law, this delayed effective date does not apply to any noncollectively bargained plans even if such plans have terms identical to those of a collectively bargained plan.

Also, the bill modifies the delayed effective date with respect to the amendments made by section 1105, relating to the $7,000 (indexed) limit on elective deferrals. Under present law, the $7,000 (indexed) limit does not apply to contributions under a collectively bargained plan made pursuant to 1 or more of the collective bargaining agreements relating to the plan for taxable years beginning before the earlier of—

(1) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991.

Under the bill, clause "(1)" above is modified to refer to the date on which the collective bargaining agreement pursuant to which the contribution is being made terminates. This change is appropriate because the $7,000 (indexed) limit is applied at the individual taxpayer level. Thus, the later termination of a collective bargaining agreement to which an individual is not subject should not affect that individual's tax treatment.

The bill also provides a delayed effective date for collectively bargained plans with respect to 2 additional sections of the Act. First, the amendments made by section 1120, applying nondiscrimination rules to tax-sheltered annuity programs (sec. 403(b)), are not to apply to collectively bargained plans in plan years beginning before the earlier of—

(1) the later of (a) January 1, 1989, or (b) the date on which the last of the collective bargaining agreements terminates (without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991.

This delayed effective date applies to the entire program.

In addition, the amendments made by section 1131, relating to the limits on deductions for contributions under a qualified plan and to the excise tax on nondeductible contributions under a qualified plan, are not to apply to contributions under a collectively bargained plan made pursuant to any of the collective bargaining agreements relating to the plan for taxable years beginning before the earlier of—

(1) January 1, 1989, or

(2) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

F. Employee Benefit Provisions

1. Nondiscrimination rules for statutory employee benefit plans (sec. 111B(a) of the bill, sec. 1151 of the Reform Act, sec. 209 of the Social Security Act, and secs. 89, 125, 129, 414, 3121, 3231, 3306, 3401, and 6652 of the Code)

In general

Under present law, new nondiscrimination rules apply to statutory employee benefit plans (sec. 89). The term "statutory employee benefit plans" includes accident or health plans and group-term life insurance plans. At the election of the employer, the term also includes qualified group legal services plans, educational assistance programs, and dependent care assistance programs.

Under the new nondiscrimination rules, a plan generally is required to satisfy 3 eligibility tests—a 50-percent test, a 90-percent/50-percent test, and a nondiscriminatory provision test—and a benefits test. Alternatively, a plan may satisfy an 80-percent coverage test, provided it also satisfies the nondiscriminatory provision test.

Nondiscrimination tests

50-percent test

Under the 50-percent test, nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement will be deemed satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible.

90-percent/50-percent test

A plan does not satisfy the 90-percent/50-percent test unless at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employee to whom the most valuable benefit is available. For purposes of this test, all plans of the same type (i.e., all benefits excludable under the same Code section) are aggregated.

For purposes of this 90-percent/50-percent test, available salary reduction is not taken into account.

Nondiscriminatory provision test

The third eligibility test provides that a plan may not contain any provision relating to eligibility to participate that by its terms or otherwise discriminates in favor of highly compensated employees. This third test is intended to disqualify arrangements only on the basis of discrimination that is not quantifiable.

Benefits test

A plan does not satisfy the benefits test unless the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type (i.e., plans providing benefits excludable under the same Code section) is at least 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type.

Alternative test

Present law also provides an alternative test that may be applied in lieu of the eligibility and benefits tests described above. If a plan benefits at least 80 percent of an employer's nonhighly compensated employees, such plan is considered to satisfy the new nondiscrimination rules. This alternative test will not apply unless the plan satisfies the nondiscriminatory provision test described above.

This alternative test applies only to accident or health plans and group-term life insurance plans. For purposes of this alternative test, an individual will only be considered to benefit under a plan if such individual receives coverage under the plan; eligibility to receive coverage is not considered benefiting under the plan.

Valuation

The Secretary is to prescribe rules regarding valuation of different benefits. With respect to health coverage, the Secretary is to establish tables prescribing the relative values of different types of health coverage.

Definitions

For purposes of applying the new nondiscrimination rules, present law provides generally applicable definitions of the following: (1) highly compensated employee (sec. 414(q)); (2) employer (including the employee leasing rules (sec. 414 (b), (c), (m), (n), (o), and (t))); (3) line of business or operating unit (as present law permits the new nondiscrimination rules to be applied separately to separate lines of business or operating units (sec. 414(r))); and (4) employees who are excluded from consideration. These definitions, other than the line of business or operating unit rule, apply generally to all employee benefit plans, not only to statutory employee benefit plans.

Qualification and reporting requirements

Employee benefit plans generally are subject to new qualification and reporting requirements (sec. 89(k) and (l)).

Effective date

In general, the amendments made by section 1151 of the Act, which provide the new rules regarding nondiscrimination, dependent care assistance programs, cafeteria plans, qualification, and reporting generally are effective for years beginning after the later of—

(1) December 31, 1987, or

(2) the earlier of—

(a) the date that is 3 months after the date on which the Secretary issues regulations under section 89, or
(b) December 31, 1988.

a. Valuation

Present Law

Under the nondiscrimination rules, the valuation of the employer-provided benefit under an accident or health plan is relevant for two purposes. First, valuation is necessary to determine whether an accident or health plan is discriminatory. Second, if a plan is discriminatory, valuation is necessary to determine the amount of the discriminatory excess that is includible in the incomes of the highly compensated employees.

For both of these purposes, the value of an employee's employer-provided benefit under an accident or health plan is the value of the coverage provided to or on behalf of the employee to the extent attributable to contributions made by the employer. For example, the value of a health plan, whether insured or self-insured, is the value of the insurance coverage, not the value of the services or the amount of claims proceeds received by a particular employee.

With respect to the valuation of any particular accident or health coverage, the Secretary is to promulgate tables that establish the relative values of accident or health coverage with any set of characteristics. Such tables may use an identifiable standard plan as a reference point. These tables are to provide the exclusive means of valuing accident or health coverage.

Such tables are to be adjusted in certain instances to take into account the specific coverage and group involved. For example, in determining the value of discriminatory coverage, the actual costs expended by the employer may be taken into account and allocated among all coverages, including the discriminatory coverage on the basis of the relative values of such coverages, as determined under the tables.

Explanation of Provision

The bill provides that any rules issued by the Secretary with respect to the valuation of accident or health coverage are to be effective as of the later of (1) the first plan year beginning at least 6 months after the issuance of such rules, or (2) the effective date specified by the Secretary for such rules. This provision is only to apply until after the effective date of the first comprehensive valuation rules as are necessary to carry out the provisions of section 89 with respect to accident or health coverage.

The bill further provides a temporary special valuation rule for accident or health coverage. This special rule applies prior to the effective date of valuation rules that are issued by the Secretary to replace such special rule. If the Secretary issues valuation rules that are intended to replace only part of such special rule, then the remaining portion of such special rule is not to be affected by such issuance.

These provisions are intended to ensure that taxpayers have timely guidance with respect to valuation issues so that they may plan for compliance with the nondiscrimination rules.

Pursuant to the special valuation rule under the bill, the value of the employer-provided benefit under an accident or health plan may, for purposes of determining if a plan is discriminatory, be calculated under any actuarially reasonable valuation method adopted by the employer. In addition, unlike under present law, an employer may, under a reasonable valuation method, use its cost in providing accident or health coverage as the value of such coverage. In such cases, the employer's cost is to be determined in the same manner that the employer determines the applicable premium for purposes of the health care continuation rules (sec. 162(k)).

This special valuation rule also permits an employer to use, as the value of accident or health coverage, the cost of such coverage modified in certain ways specified below.

First, to facilitate planning, an employer may use, as the employer cost of accident or health coverage for a plan year, the average annual cost (determined in the manner described above) of substantially similar coverage provided during the immediately preceding one or two years.

The employer may also make reasonable adjustments to its cost to eliminate cost differences between coverages attributable to (1) differences in the cost of accident or health coverage in different geographic areas, and (2) the demographic characteristics of the covered employees. For example, assume that the employer provides individual coverage to employees in State X that costs $1,000 per employee, but that would cost $1,200 per employee in State Y. Assume further that the employer also operates in State Y and tests its State X employees with its State Y employees under section 89. In such case, the employer may, for example, treat the individual coverage provided in State X as costing $1,200 for purposes of testing such coverage with the coverage provided in State Y.

Another example of a permissible adjustment under the above rule would be an age-related adjustment. For example, assume that the employer provides individual coverage to a group of young employees that costs $800 per employee, but if provided to a group of the employer's older employees would cost $1,100. In such a case, the employer may, for example, treat the individual coverage provided to the young employees as costing $1,100 for purposes of testing such coverage with the coverage of the older employees.

The employer may also adjust its cost to eliminate differences in costs between coverages that are attributable to differences in utilization of certain health care features that are common to the different coverages. For example, if all of an employer's cancer cases arise under a specific health plan and the cancer-relevant health features of such plan are common to other health plans, the costs of such plans may be adjusted to eliminate this utilization distortion. This adjustment is to be made after the adjustments described above and is to be made by estimating the cost of each plan with the common features as if the utilization had been evenly distributed among the plans.

All of an employer's accident or health plans that are tested together under section 89 are to be valued under the same actuarially reasonable valuation method. Thus, if an employer uses cost as its valuation method and adjusts its cost under one or more of the rules described above, the employer must use cost and make the same adjustments to all plans tested together under section 89. In addition, as is the case with all other aspects of the nondiscrimination rules, the employer must maintain records of its valuation method and the basis for this method (including the basis for the adjustments described above).

This rule, requiring an employer to use the same valuation method for all of its plans, means that, for example, 2 health plans with identical costs (if cost is used) or coverages (if a non-cost valuation method is used) may not be assigned different values merely because one is a health maintenance organization and one is an indemnity plan. Similarly, the same valuation method should be used for valuing, for example, dental plans, hearing care plans, vision plans, physical examination plans, substance abuse programs, etc.

The valuation method described above is, as noted, applicable in determining if an accident or health plan is discriminatory. Once this determination is made, the determination of the discriminatory excess, if any, that is includible in the incomes of the highly compensated employees is similar to the determination under present law. The first step is to determine the percentage of any coverage that is discriminatory. This percentage is then multiplied by the employer's actual cost in providing the entire coverage to determine the discriminatory excess. The bill clarifies that such actual cost is to be determined in the same manner that the employer determines the applicable premium for purposes of the health care continuation rules. The bill modifies present law by allowing cost to be adjusted for this purpose for differences in utilization in the manner described above. None of the other adjustments described above is permitted for this purpose.

For example, assume that, for testing purposes, an employer determines that coverage provided to all its highly compensated employees has a value of $2,000. After applying the section 89 nondiscrimination rules, the employer determines that $200 of this $2,000 — 10 percent — constitutes discriminatory excess. The employer then multiplies 10 percent by its actual cost (with or without the utilization adjustment noted above). If the employer's actual cost in providing the coverage is $1,600, then $160 (10 percent of $1,600) is includible in the incomes of the highly compensated employees.

b. Employers with no nonhighly compensated employees

Present Law

Under present law, the nondiscrimination rules applicable to statutory employee benefit plans are applied by reference to the eligibility of nonhighly compensated employees to participate in a plan or to the amount of benefits provided to nonhighly compensated employees under a plan. It is unclear under present law how these nondiscrimination rules apply in the case of an employer who has no nonhighly compensated employees.

Explanation of Provision

The bill clarifies that the nondiscrimination rules do not apply to an employer in a year in which such employer has no nonhighly compensated employees. As is so with respect to the nondiscrimination rules generally, this rule is to apply separately with respect to former employees under rules prescribed by the Secretary.

c. Plan aggregation—accident or health plans

Present Law

Under present law, each different option generally is a separate plan for testing purposes. However, for purposes of the 50-percent eligibility test and the alternative 80-percent test, comparable accident or health plans may be aggregated (sec. 89(g)(1)).

Explanation of Provision

The bill provides that, under rules prescribed by the Secretary, if an employee is eligible for (in the case of the 50-percent test) or receives coverage under more than 1 accident or health plan, then, for purposes of the 50-percent test and the alternative 80-percent test, such plans are required to be considered 1 plan with respect to such employee.

For example, assume that an employer maintains 2 plans: 1 benefiting all employees with a value of $950 and a second benefiting only highly compensated employees with a value of $1,000. The highly compensated employees receiving benefits from both plans are to be treated for purposes of the 50-percent test and the alternative 80-percent test as receiving $1,950 of benefits from 1 plan while the nonhighly compensated employees are to be treated as receiving $950 of benefits from a separate plan. Under the comparability rules (sec. 89(g)(1)), these plans would not be comparable so that the plan covering the highly compensated employees would satisfy neither the 50-percent test nor the alternative 80-percent test.

This rule, requiring certain plans to be treated as 1 plan with respect to certain employees, supersedes the rule of present law allowing employers to structure options in different ways as long as all coverage within a plan is identical.

d. Plan definition—group-term life insurance

Present Law

Under present law, each different option generally is a separate plan for testing purposes. This means, for example, that if 2 types of insurance coverage vary in any way (including the amount of required employee contributions), they will be considered separate plans.

Explanation of Provision

It is intended that there be an additional exception to the general rule that if 2 types of insurance coverage vary in any way, they will be considered separate plans. Pursuant to this exception, under rules prescribed by the Secretary, if with respect to group-term life insurance coverage, the required employee contributions vary according to the age of the employee, this variation will not preclude treatment of the coverage as a single plan. Thus, for example, if an employer offers every employee group-term life insurance coverage equal to one times compensation, provided that the employee contribute one quarter of the cost of such coverage, this will constitute a single plan even if the cost of each employee's coverage is determined on the basis of such employee's age. (Present law allows group-term life insurance that varies in proportion to compensation to be considered a single plan.)

If an employer uses the special rule described above, and employee-purchased coverage is not treated as employer-provided, then the amount of employer-provided group-term life insurance coverage with respect to any employee is the amount that bears the same relationship to the total coverage for such employee as the employer's contribution (determined on an age-rated basis) bears to the age-rated cost of such employee's total coverage. For example, if an employee contributes one quarter of the age-rated cost of $100,000 of coverage, and employee-purchased coverage is not treated as employer-provided, the employer-provided group-term life insurance coverage with respect to such employee is $75,000.

If the employer does not use the special rule described above, and employee-purchased coverage is not treated as employer-provided, the amount of employer-provided group-term life insurance coverage with respect to any employee is determined in the same manner except that the total cost of any employee's coverage and the employer's contributions with respect to such coverage are to be determined without regard to the employee's age.

If an employer uses the special rule described above with respect to any group-term life insurance, then the employer is required to use the special rule with respect to all group-term life insurance coverage of the employer. Thus, with respect to such an employer, coverage available for a required employee contribution that does not vary according to age would not be considered a single plan. Of course, this rule applies separately to any line of business or operating unit if the employer applies the rules of section 89 separately to such line of business or operating unit pursuant to section 89(g)(5).

e. Family coverage

Present Law

Under present law, a special rule applies in the case of family coverage under an accident or health plan. Pursuant to this special rule, for purposes of the 90-percent/50-percent test, the coverage for employees and the coverage for spouses and dependents may be tested separately, as if they constituted 2 different types of plans. Further, for purposes of the same test, with respect to coverage of spouses and dependents, the employer may disregard employees who do not have a spouse or dependent. An employer who elects this latter optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether employees have a spouse or dependent.

Explanation of Provision

The bill deletes the rule allowing employers to apply the 90-percent/50-percent test separately with respect to family coverage and to take into account for such purpose only employees who have a family. This rule implies that family coverage cannot be considered available to an employee who does not have a family.

Under the bill, family coverage (i.e., coverage of an employee's family, which is considered separate from coverage of the employee) may be considered to be available (if otherwise available) or provided (if otherwise provided) to an employee despite the fact that the employee does not have a family. The purpose of this rule is to relieve employers from the burden of determining which employees have families.

This rule alone, however, could produce inappropriate results in certain very limited circumstances and it is intended that the nondiscriminatory provision test be applied to prevent such results. Thus, if, under the facts and circumstances, it is clear that the employer is, by using the above rule that allows family coverage to be considered to be available or provided to an employee who does not have a family, evading the other nondiscrimination tests, the nondiscriminatory provision test is not to be considered satisfied with respect to the relevant plan or plans.

For example, assume that an employer had 2 highly compensated employees and 8 nonhighly compensated employees, none of whom had families. The employer provided $3,000 of employee coverage to each of the 2 highly compensated employees. For the same year, the employer provided family coverage to each of the 8 nonhighly compensated employees the value of which was $3,000 per employee under the applicable valuation method. Because comparable plans may be aggregated for purposes of the alternative 80-percent test, the employer would satisfy such test. This is not the result intended by Congress, since the facts of this example clearly indicate that by using the rule allowing family coverage to be considered to be provided to employees without families, the employer is avoiding providing the nonhighly compensated employees truly nondiscriminatory benefits. Thus, the nondiscriminatory provision test would not be considered satisfied with respect to the plan covering the highly compensated employees.

This application of the nondiscriminatory provision test applies not only with respect to evasion of the alternative 80-percent test, but to evasion of any of the tests. For example, the nondiscriminatory provision test would not be considered satisfied with respect to a plan maintained by the employer in the above example for its highly compensated employees if such plan satisfied the 90-percent/50-percent test by virtue of a second plan making family coverage available to the nonhighly compensated employees.

f. Sworn statements—benefits test

Present Law

For purposes of applying the benefits test to accident or health plans, an employer generally (see sec. 89(g)(2)(D)) may elect to disregard any employee or family member of an employee if such individual is covered by a health plan that provides core benefits and that is maintained by another employer of the employee or of a member of the employee's family. An employer who elects this optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether individuals have core health coverage from another employer.

Explanation of Provision

The bill provides that, with respect to an employer ("first employer"), an individual may be considered to have core health benefits from another employer of such individual or of a member of such individual's family, despite the fact that no sworn statement is obtained and maintained to that effect, if (1) the first employer makes available to an employee, at no cost, core health benefits with respect to such individual, and (2) no health benefits under any plan of the first employer are provided with respect to such individual. For purposes of this rule, any financial detriment with respect to core health benefits, regardless of whether it is direct or indirect, current or future, fixed or contingent, is considered a cost rendering this special rule inapplicable. A benefit that is available to an employee on the condition that such employee reduce his salary or forego another benefit is considered available at a cost.

Under present law, with respect to an employer that elects to disregard individuals covered (or deemed covered under the rule described above) by another employer's core health benefits, in the absence of a sworn statement, a highly compensated employee is treated as (1) covered by a plan of another employer providing core health benefits, and (2) not having a spouse or dependent. Thus, the special rule under the bill described above only affects non-highly compensated employees.

g. Sworn statements—80-percent test

Present Law

For purposes of applying the benefits test and the alternative 80-percent test to accident or health plans, the coverage for employees and the coverage for spouses and dependents may be tested separately, as if they constituted 2 different types of plans. For purposes of the same tests, with respect to separate testing of the coverage of spouses and dependents, the employer may disregard employees who do not have a spouse or dependent. An employer who elects this latter optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether employees have a spouse or dependent.

With respect to an employer electing the latter special rule described above, in the absence of a sworn statement, a highly compensated employee is treated as, *inter alia*, not having a spouse or dependent. If an employee is treated as not having a spouse or dependent, any coverage provided to any spouse or dependent of that employee generally is disregarded. For purposes of applying the benefits test, however, the family of a highly compensated employee may not be disregarded nor may coverage provided to such family be disregarded if the coverage provided with respect to such family has a value in excess of 133-1/3 percent of the average employer-provided benefit provided with respect to families of non-highly compensated employees.

Explanation of Provision

Under the bill, a rule similar to the special "133-1/3-percent rule" applies for purposes of the alternative 80-percent test.

For purposes of the 80-percent test, the general rule is that a group of plans are comparable and may be aggregated if the value of the employer-provided coverage provided to each covered employee in the plan with the lowest such value is at least 95 percent of the value of the employer-provided coverage provided to each covered employee in the plan with the highest such value. However, if a plan with a greater value than permitted under the previous sentence satisfies section 89(d)(2) based on actual coverage provided rather than on eligibility, such plan may be aggregated with the group of less valuable plans for purposes of the 80-percent test.

Under the analogue to the 133-1/3-percent rule, for purposes of the 80-percent test, the family of a highly compensated employee may not be disregarded nor may coverage provided to such family be disregarded if the coverage provided to any spouse and dependents of such employee is provided under a plan that would need to rely on the section 89(d)(2) test to be aggregated with a group of plans satisfying the 80-percent test. Of course, under the 80-percent test, if no group of plans satisfies the 80-percent test, no coverage provided to family members of highly compensated employees may be disregarded.

h. Excluded employees

Present Law

Under present law, certain classes of employees are disregarded in applying the nondiscrimination rules if neither the plan, nor any other plan of the same type, is available to any employee in the same class. Two of the disregarded classes are (1) in the case of an accident or health plan (other than with respect to noncore benefits), employees who have not completed 6 months of service (or such shorter period of service as may be specified in the plan); and (2) in the case of any other statutory employee benefit plan (including an accident or health plan with respect to noncore benefits), employees who have not completed 1 year of service (or such shorter period of service as may be specified in the plan).

An employer is to exclude an employee, on the grounds that such employee has not satisfied the required period of initial service, during the period prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement. In general, this exclusion does not apply if any employee is eligible under any plan of the same type prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement.

In addition, the legislative history of the Act provided certain rules of convenience, relating to the time at which the nondiscrimination rules are to be applied, that were intended to reduce the administrative burden of applying the nondiscrimination rules.

Explanation of Provision

Under the bill, the rule regarding the exclusion of employees between the date of actual satisfaction of the initial service requirement and the first day of the calendar month immediately following such satisfaction is modified so that an employer may use, instead of the first day of the next calendar month, the first day of a period of less than 31 days specified by the plan. For example, assume that an employer required 60 days of service for participation in a health plan, but did not allow participation to commence other than on the first day of 4-week periods. Such employer is to exclude employees during the period prior to the first day of the 4-week period following satisfaction of the 60-days-of-service requirement.

The Secretary is to provide corresponding changes to the rules of convenience relating to the time for testing described in the legislative history of the Act.

This amendment, allowing use of a period of less than 31 days, provides employers with flexibility without adversely affecting the policy of the nondiscrimination rules.

i. Self-employed individuals

Present Law

Under the Act, it is unclear whether self-employed individuals are treated as employees for purposes of the nondiscrimination rules applicable to statutory employee benefit plans.

Explanation of Provision

The bill clarifies that, for purposes of applying the nondiscrimination rules to statutory employee benefit plans, the term "employee" includes any self-employed individual (as defined in sec. 401(c)(1)), and the term "compensation" includes such individual's earned income (as defined in sec. 401(c)(2)).

In addition, an individual who owns the entire interest in an unincorporated trade or business is to be treated as his or her own employer. A partnership is to be treated as the employer of each partner who is treated as an employee under the rule described above.

These rules do not affect whether a self-employed individual may exclude a benefit provided under a statutory employee benefit plan. For example, group-term life insurance provided to a self-employed individual may not be excluded by the self-employed individual because section 79 does not apply to self-employed individuals. The effect of this provision of the bill is to count a self-employed individual as an employee even though such individual is not eligible for the exclusion. Generally, this will facilitate compliance with the nondiscrimination rules, since self-employed individuals, who generally are highly compensated employees under the applicable definition (sec. 414(q)), are taken into account but treated only as eligible for and receiving benefits that are excludable or deductible. Thus, for example, with respect to health benefits, a self-employed individual is treated as receiving (or eligible for) a benefit equal to 25 percent of the amount paid (or payable) for health insurance, since that is the only amount that is tax-favored with respect to a self-employed individual (secs. 106 and 162(m)).

j. Qualification rule

Present Law

Under present law, certain employee benefit plans, including accident or health plans, are subject to certain qualification rules (sec. 89(k)). For example, the plan is required to be in writing.

Explanation of Provision

Standard short-term sick pay plans were not intended to be subject to the qualification rules of section 89(k). Thus, under rules prescribed by the Secretary, such plans are to be exempted from the qualification rules. It is anticipated that the rules prescribed by the Secretary will identify standard short-term sick pay plans by reference to the length of time the employer will provide benefits while an individual is absent from work.

k. Sanctions

Present Law

Year of inclusion

Under present law, if a plan is discriminatory in a plan year, highly compensated employees are taxable on the value of the discriminatory excess in their taxable year in which or with which the plan year ends.

Discriminatory excess

The discriminatory excess is defined as the amount of the otherwise nontaxable employer-provided benefit (including benefits purchased with elective contributions) that would have to have been purchased with after-tax employee contributions by the highly compensated employees in order for all of the nondiscrimination tests to be satisfied. In the case of group-term life insurance, the value of discriminatory coverage is the greater of the cost of coverage under section 79(c) or the actual cost of coverage.

Of course, as is generally the case, the taxpayer has the burden of proof with respect to establishing the discriminatory excess. Thus, the discriminatory excess includes all employer-provided benefits for highly compensated employees except to the extent that the taxpayer maintains sufficient records to demonstrate to the Internal Revenue Service that such benefits do not constitute discriminatory excess.

Qualification rule sanction

If a plan fails to satisfy the new qualification requirements (sec. 89(k)), employees covered under the plan generally are to include in gross income the employer-provided benefit under the plan. For this purpose, even in the case of an insurance-type plan, an employee's employer-provided benefit is the value of the benefits, not the coverage, attributable to employer contributions.

Employer sanction

If the employer does not report the discriminatory excess (or other amounts includible under sec. 89) in a timely manner, the employer may be subject to an employer-level sanction (sec. 6652(l)). This sanction applies without regard to whether the relevant benefit was automatically subject to section 89 or whether it was only subject to section 89 due to an election by the employer under section 89(i)(2).

Welfare benefit funds

In general, if a voluntary employees' beneficiary association (VEBA) (sec. 501(c)(9)) or group legal services organization (GLSO) (sec. 501(c)(20)) is part of a discriminatory plan, the VEBA or GLSO is not to be exempt from tax under section 501(a) (sec. 505). With respect to employee benefits subject to the new nondiscrimination rules of section 89, a discriminatory plan for this purpose is a discriminatory employee benefit plan within the meaning of section 89(c).

In addition, if an employer maintains a welfare benefit fund and there is a disqualified benefit provided during any taxable year, a tax is imposed on the employer equal to 100 percent of the disqualified benefit. The term "disqualified benefit" includes any post-retirement medical benefit or life insurance benefit provided with respect to a highly compensated employee under a discriminatory plan (within the meaning of sec. 505).

Explanation of Provision

Year of inclusion

Under present law, if a plan is discriminatory and the plan year is, for example, the calendar year, the employer has only 1 month to determine the discriminatory excess with respect to the highly compensated employees in order to file accurate Forms W-2 in a timely manner. In many cases, this is not a sufficient period of time. Thus, the bill provides a special rule with respect to plans with a plan year ending after September 30 and on or before December 31 of a calendar year.

Under this special rule, an employer may elect to have the discriminatory excess included in the incomes of highly compensated employees in their taxable year following the taxable year with or within which the plan year ends. If an employer makes such an election, however, the employer's deduction relating to such discriminatory excess is to be allowable only in the employer's taxable year with or within which ends the plan year following the plan year in which the discriminatory excess occurred. It is not intended, however, that an employer be permitted to avoid the deferral of the deduction through the use of a short plan year following the plan year in which the discriminatory excess occurred.

Discriminatory excess

For purposes of determining and allocating the discriminatory excess with respect to a group-term life insurance plan, employer-provided coverage over $50,000 will be treated as nontaxable under the bill. Thus, to the extent that the discriminatory coverage does not exceed the total coverage over $50,000, the effect of a finding of discrimination is simply the inclusion in income of the excess, if any, of the actual cost of the discriminatory coverage over the cost of such coverage under section 79(c).

For example, assume an employee receives $150,000 of employer-provided coverage and the $100,000 excess over $50,000 is included in income, at the cost determined under section 79(c), pursuant to section 79(a). Assume further that $25,000 of such employee's coverage is determined to be discriminatory. The effect of this finding of discrimination is that the excess, if any, of the actual cost of such $25,000 of coverage over the section 79(c) cost of such coverage is included in the employee's income (in addition to the section 79(c) cost of the $100,000 of coverage (i.e., the amount over $50,000)).

Qualification rule sanction

If a plan to which section 505 applies—generally, a plan part of which is a VEBA or a GLSO—violates the new qualification requirements (sec. 89(k)), the VEBA or GLSO is not to be exempt from tax under section 501(a). A plan failing to satisfy the new qualification requirements is not the type of plan for which the VEBA or GLSO tax exemption was established.

In addition, the bill provides that in the case of a group-term life insurance plan that fails the qualification rule, the benefits provided under the plan are to be included in the beneficiary's income rather than the employee's.

The bill further provides for the coordination of the sanction for failure to satisfy the qualification rules with the sanction for discrimination. Generally, any amount included in the income of a highly compensated employee attributable to discriminatory coverage is to offset the amount includible under section 89(k) with respect to the same highly compensated employee for the same coverage. Thus, for example, assume a highly compensated employee includes $100 in income under section 89(a) for discriminatory health coverage provided during a plan year, and such health coverage does not satisfy section 89(k). The only health benefits that are includible under section 89(k) attributable to the coverage provided during that plan year are amounts in excess of $100.

If, however, any discriminatory excess would be included in the income of a highly compensated employee for a year subsequent to the year of inclusion under section 89(k) with respect to the same coverage, the coordination described above is to work in reverse, i.e., the section 89(k) inclusion is to offset the inclusion of the discriminatory excess.

Employer sanction

If an employer does not report a discriminatory excess (or other amount includible under sec. 89) in a timely manner, the employer may be subject to an employer-level sanction. Under the bill, it is clarified that the employer-provided benefit subject to the employer sanction is determined under the general rules applicable under section 89 except that the special rule relating to group-term life insurance plans, under which employees are assumed to be age 40, does not apply. Of course, the adjustment of the employer-provided benefit under a group-term life insurance plan based on the employee's compensation also does not apply.

Welfare benefit funds

The sanctions of present law with respect to discriminatory VEBA's, GLSO's, and other welfare benefit funds are inconsistent with the general approach under section 89 to apply the sanction solely with respect to the discriminatory amount. The bill modifies the sanctions accordingly.

Under the bill, if section 89 applies to a plan, a VEBA or GLSO that is part of the plan does not lose its tax-exempt status under section 501(a) merely because the plan is a discriminatory employee benefit plan (within the meaning of sec. 89(c)). In lieu of this sanction, the bill imposes an excise tax on an employer maintaining a welfare benefit fund if a discriminatory employee benefit plan is part of the fund for the plan year. The tax applies to the taxable year of the employer with or within which the plan year ends.

The amount of this excise tax is determined as follows. The first step is to determine the lesser of (1) the aggregate excess benefits (within the meaning of sec. 89(b)) provided under the plan for the plan year, or (2) the taxable income of the fund for the plan year. For this purpose, the taxable income of the fund is determined without regard to an exemption from tax pursuant to section 501(c)(9) or (c)(20). The lesser of those 2 amounts is then multiplied by the highest rate applicable to taxable income under section 11. This product then is offset by the amount of income tax imposed on the fund for the plan year determined under rules prescribed by the Secretary. This result is the amount of the excise tax.

The bill also modifies the 100-percent excise tax applicable to disqualified benefits in the case of a post-retirement medical benefit or life insurance benefit that is subject to section 89. The bill provides that the amount of the disqualified benefit subject to the tax is not to exceed the aggregate excess benefits (within the meaning of sec. 89(b)) provided under the plan.

l. Inclusion in wages

Present Law

Under present law, amounts that are includible in an employee's income because the section 89 requirements relating to employee benefit plans are not satisfied are not in all cases treated as wages (or compensation) for employment tax purposes.

Explanation of Provision

Under the bill, amounts that are includible in gross income by reason of section 89 (either directly or indirectly (as in the case of section 129(d)(1)(B))) are included in wages (or compensation), as of the time includible in gross income, for purposes of the Federal Insurance Contributions Act (sec. 3121), the Railroad Retirement Tax Act (sec. 3231(e)), the Federal Unemployment Tax Act (sec. 3306), income tax withholding (sec. 3401), and the Social Security Act (sec. 209). Of course, such inclusion is subject to the applicable limits on wages (or compensation).

m. Dependent care assistance programs

Present Law

Present law provides a benefits test applicable to dependent care assistance programs that are not treated as statutory employee benefit plans under section 89 (sec. 129(d)(8)). For purposes of applying this benefits test to salary reduction amounts, employees with compensation (as defined in sec. 414(q)(7)) below $25,000 are to be disregarded. This special rule does not apply if the dependent care assistance program is treated as a statutory employee benefit plan under section 89.

Explanation of Provision

For purposes of applying the special benefits test (sec. 129(d)(7), as redesignated by the bill) to salary reduction amounts under a dependent care assistance program that is not treated as a statutory employee benefit plan under section 89, an employer may elect to take into account employees with compensation (as defined in sec. 414(q)(7)) below $25,000. Thus, the employer may elect to take into account all employees with compensation below $25,000 or may disregard employees with compensation below any specified amount lower than $25,000.

n. Cafeteria plans

Present Law

Definition of a cafeteria plan

Under present law, the definition of a cafeteria plan includes a plan only offering a choice between nontaxable benefits (sec. 125).

Qualified benefits

To qualify as a cafeteria plan, a plan may not offer benefits other than cash and qualified benefits. The term "qualified benefits" generally means any benefit that, with the application of section 125(a), is excludable from an employee's income by reason of a provision of Chapter 1 of the Code (other than secs. 117, 124, 127, or 132). In addition, the term includes (1) any group-term life insurance coverage that is includible in income only because it is in excess of $50,000, and (2) any other benefit permitted under regulations.

Explanation of Provision

Definition of a cafeteria plan

The bill amends the definition of a cafeteria plan so that a choice only between nontaxable benefits is not a cafeteria plan. The inclusion of a choice between nontaxable benefits as a cafeteria plan would require, to make the provision effective as a practical matter, additional amendments not intended by Congress. For example, under present law, a choice between nontaxable benefits, one of which constituted deferred compensation, would generally not be a cafeteria plan in light of the prohibition on deferred compensation in a cafeteria plan. Thus, an employer could simply add to any choice between nontaxable current benefits the choice of a nominal nontaxable deferred benefit; this would at least arguably remove the arrangement from the definition of a cafeteria plan. Although this and other problems with the new definition could have been individually addressed with additional rules, such rules would have added complexity not contemplated by Congress.

Sanctions

The bill also clarifies that, in the case of a cafeteria plan that fails the cafeteria plan nondiscrimination test (sec. 125(b)(1)), only highly compensated employees are taxable on the available taxable benefits. In the case of a cafeteria plan that fails the key employee concentration test (sec. 125(b)(2)), the bill clarifies that only key employees are taxable on the available taxable benefits.

Qualified benefits

In addition, the bill modifies the definition of qualified benefits. Under the bill, the term "qualified benefits" includes benefits that would be qualified benefits but for the fact that they are includible in an employee's income under section 89(a). Thus, if, for example, there is a discriminatory excess with respect to a health plan offered under a cafeteria plan, such discriminatory excess will not cause the cafeteria plan to cease to be a cafeteria plan.

The bill also modifies the special definition of qualified benefits used for purposes of determining whether under the key employee concentration test (sec. 125(b)(2)), the qualified benefits provided to key employees under a cafeteria plan exceed 25 percent of the aggregate of such benefits provided to all employees under the plan. For this purpose, benefits that are includible in income (without regard to the key employee concentration test of sec. 125(b)(2)) are disregarded.

o. Continuation of health care

Present Law

Under present law, for purposes of most employee benefit provisions, certain aggregation rules are applied (sec. 414(b), (c), (m), (o), and (t)). Thus, related employers generally are treated as a single employer for purposes of these provisions. Further, under certain circumstances, leased employees are treated as employees of the lessee (sec. 414(n)).

Explanation of Provision

The bill extends the rules aggregating related employers (sec. 414(b), (c), (m), (o), and (t)) and the employee leasing rules (sec. 414(n)) to the continuation-of-health-care rules under section

162(i)(2) and 162(k) and under section 2201(b) of the Public Health Service Act. (The Act applied such aggregation and leasing rules for purposes of the continuation-of-health-care rules under sec. 106 and the Employment Retirement Income Security Act of 1974 (ERISA).) Such extension presents evasion of the continuation-of-health-care rules by the use of multiple employers, employee leasing, or other arrangements.

Under the bill, this extension and the application under the Act of the same aggregation and leasing rules to section 106 (relating to the exclusion from income of employer-provided accident or health coverage) and to the continuation-of-health-care rules of ERISA are effective for years beginning after 1986.

p. Effective date

Present Law

In general, the amendments made by section 1151 of the Act, which provide the new rules regarding nondiscrimination, dependent care assistance programs, cafeteria plans, qualification, and reporting generally are effective for years beginning after the later of—

(1) December 31, 1987, or

(2) the earlier of—

(a) the date that is 3 months after the date on which the Secretary issues regulations under section 89, or

(b) December 31, 1988.

Explanation of Provision

Under the bill, an employer may elect to apply the new rules of section 1151 of the Act (including the nondiscrimination rules, qualification rules, reporting rules, and cafeteria plan rules) to certain group-term life insurance plans in plan years beginning after October 22, 1986. The plans for which this election is available are described in section 125(c)(2)(C).

2. Deductibility of health insurance costs of self-employed individuals (sec. 111B(b) of the bill, sec. 1161 of the Reform Act, and sec. 162(m) of the Code)

Present Law

Under certain circumstances, a self-employed individual may deduct 25 percent of the amounts paid for health insurance for a taxable year on behalf of the individual and the individual's spouse and dependents (sec. 162(m)). The deduction is allowable in calculating adjusted gross income.

The deduction is limited to the taxpayer's earned income (within the meaning of sec. 401(c)).

Explanation of Provision

The bill clarifies that, consistent with the Congressional intent reflected in the Statement of Managers, the amount deductible under section 162(m) is not taken into account in computing net earnings from self-employment (sec. 1402(a)) or for purposes of the

Social Security Act. Therefore, the amounts deductible under section 162(m) do not reduce the income base for purposes of the self-employed individual's social security tax or for purposes of benefit credit under the Social Security Act.

Under the bill, the deduction under section 162(m) is limited to the earned income derived by the taxpayer from the trade or business with respect to which the plan providing the health insurance is established.

3. $5,000 limit on dependent care assistance exclusion (sec. 111B(c) of the bill, sec. 1163 of the Reform Act, and sec. 129 of the Code)

Present Law

Under present law, if certain requirements are satisfied, gross income of an employee does not include amounts paid or incurred by the employer for dependent care assistance provided to the employee. With respect to any taxpayer, this exclusion from gross income does not apply to amounts in excess of $5,000 in a taxable year ($2,500 in the case of a separate return by a married individual).

Explanation of Provision

Under the bill, the $5,000 (or $2,500) limit applies to the amount of dependent care services that is covered by a dependent care assistance program and that is received by a taxpayer during a taxable year, without regard to whether the taxpayer has received payment from the employer for any expenses paid or incurred by the taxpayer in connection with such services. If, however, the limit is exceeded in any year, the excess is includible in the taxpayer's income in the year in which the dependent care assistance is received from the employer. In the case of a payment by the employer to the employee for dependent care services received by the employee, the dependent care assistance is considered received when the payment is received.

For example, assume that in 1988, unmarried employee A, whose taxable year is the calendar year, incurred $6,000 of dependent care expenses (which he paid); in 1989, the figure was $5,000. During this period, A's employer B maintained a dependent care assistance program that satisfied the requirements of section 129. Pursuant to the program, B is to reimburse A for all his dependent care expenses. However, during 1988, B only made $3,000 of payments. During 1989, an additional $7,000 of payments were made. Thus, at the end of 1989, B owes A $1,000 under the program.

Under the bill, the $5,000 limit on dependent care services covered by a program is exceeded in 1988 by $1,000. However, A did not receive the last $1,000 attributable to 1988 in 1988. Thus, no amount is includible in A's income for 1988 with respect to the dependent care assistance program. Under the bill, however, the first $3,000 paid by B to A under the program after 1988 is considered to relate to 1988. Thus, the third thousand dollars paid to A in 1988 is includible in A's income.

In 1989, A only receives $5,000 worth of dependent care services covered by a dependent care assistance program. This equals the limit with respect to A. Thus, other than the $1,000 attributable to 1988, none of the $7,000 of payments is includible in A's income and the $1,000 left unpaid at the end of 1989 will not be includible when paid.

These provisions for applying the $5,000 (or $2,500) limit are intended to conform to the manner in which employers maintain their records and thus are intended to facilitate administration of the limit. In addition, in comparison to applying the limit strictly on a cash basis, these provisions prevent avoidance of the limit by, for example, delaying the date of payment. The provisions can also prevent inappropriate application of the limit, such as in instances in which payment for one year is unavoidably delayed into a second year for which a full $5,000 will be paid for current expenses.

These provisions with respect to the $5,000 limit generally apply to taxable years beginning after December 31, 1987, with 2 modifications. First, a taxpayer may elect to have the provisions apply to taxable years beginning after December 31, 1986. The election may be made by a taxpayer by filing an income tax return in a manner consistent with these provisions for any taxable year beginning before January 1, 1988.

The second modification applies to any taxpayer who does not make the election described above. Such taxpayers are subject to the following transition rule. Any dependent care services covered by a dependent care assistance program that are received by the taxpayer in a taxable year beginning in 1987 are to be treated as provided in the taxpayer's first taxable year beginning after December 31, 1987, if the employer payment for such services is not received in the year in which the services are received.

For example, assume that in 1987, unmarried employee C, whose taxable year is the calendar year, incurred $6,000 of dependent care expenses (which she paid); in 1988, the figure was $5,000. During this period, C's employer D maintained a dependent care assistance program that satisfied the requirements of section 129. Pursuant to the program, D is to reimburse C for all her dependent care expenses. However, during 1987, D only made $5,000 of payments. During 1988, an additional $5,500 of payments were made. Thus, at the end of 1988, D owes C $500 under the program.

Assume that C does not make the election described above. In 1987, C only received $5,000 in employer payments and thus under the rules in effect prior to the bill provision has no inclusion in 1987 attributable to those payments. In 1988, when the bill provisions first apply to C, C only receives $5,000 worth of dependent care services covered by a dependent care assistance program. Thus, without regard to the special transition rule, C would have no inclusion attributable to services received in 1988.

Because C did not make the election, however, the special transition rule applies to her. Under this rule, the first step is to determine the amount of covered services received by C in 1987 for which no payment is made by D during 1987. In this example, such amount is $1,000. This amount of services is then considered to have been received by C in 1988. Thus, the total covered services C is considered to receive in 1988 is increased from $5,000 to $6,000, a total that is $1,000 over the limit. Because C receives $5,500 in payments from D in 1988, she has an inclusion of $500 in 1988. In addition, the next $500 that C receives from D after 1988 is considered to relate to 1988 and thus is includible in her income.

4. Treatment of certain full-time life insurance salespersons (sec. 111B(e) of the bill, sec. 1166 of the Reform Act, and sec. 7701(a)(20) of the Code)

Present Law

Under present law, a full-time life insurance salesperson is treated as an employee for purposes of the cafeteria plan provision with respect to accident and health plans.

Explanation of Provision

The bill clarifies Congressional intent, reflected in the Statement of Managers, to treat full-time life insurance salespersons as employees for purposes of the cafeteria plan provision with respect to benefits that the salesperson is otherwise permitted to exclude from income.

5. Exclusion of cafeteria plan elective contributions from wages for purposes of employment taxes (sec. 111B(a) of the bill, sec. 1151(d) of the Reform Act, sec. 209(e) of the Social Security Act, and secs. 3121(a)(5) and 3306(b)(5) of the Code)

Present Law

Under present law, no amount is included in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits of the plan. Under the Act, this exception from the principles of constructive receipt generally also applies for purposes of FICA and FUTA taxes. The exception does not apply, however, for FICA and FUTA tax purposes with respect to elective deferrals under a qualified cash or deferred arrangement that is part of a cafeteria plan.

Explanation of Provision

The bill clarifies that the exclusion from wages provided under the Act with respect to FICA and FUTA taxes applies to payments and benefits under a cafeteria plan if (1) it is reasonable to believe that (if sec. 125 applied for purposes of FICA and FUTA taxes) section 125 would not treat any wages as constructively received, and (2) the payments would not be treated as wages if provided outside of the cafeteria plan. As is the case for income tax purposes, the failure of a cafeteria plan to satisfy the discrimination test does not cause inclusion with respect to nonhighly compensated employees and the failure of a cafeteria plan to satisfy the key employee concentration test does not cause inclusion with respect to non-key employees.

For example, no amount is included in any employee's wages for FICA and FUTA tax purposes attributable to the employee's election under a cafeteria plan that satisfies the applicable discrimination test and key employee concentration test of a health benefit that is otherwise excludable from wages. Of course, a collectively bargained plan that is deemed to be nondiscriminatory for income tax purposes (sec. 125(f)) is deemed to meet the cafeteria-plan discrimination test (sec. 125(b)(1)) for purposes of this rule.

An example of a benefit that would not be excludable from wages would be employer-provided group-term life insurance that would, pursuant to the amendment made by section 9003 of the Omnibus Budget Reconciliation Act of 1987, be includible in wages if provided outside of a cafeteria plan.

6. Tax treatment of qualified campus lodging (sec. 111B(d) of the bill, sec. 1164 of the Reform Act, and sec. 119(d) of the Code)

Present Law

Under present law, the fair market value of use (on an annualized basis) of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)) is treated as not greater than 5 percent of the appraised value for the lodging, but only if an independent appraisal of the fair market value of the lodging is obtained by a qualified appraiser under rules prescribed by the Secretary. For purposes of this rule, the appraised value is to be determined as of the close of the calendar year in which the taxable year begins.

The purpose of this provision is to avoid disputes between educational institutions and the Internal Revenue Service regarding whether an individual has income attributable to the use, for a specified rent, of employer-furnished lodging located on a campus of, or in the proximity of, the educational institution.

Explanation of Provision

If the appraised value of qualified campus lodging is determined as of the close of the calendar year in which the taxable year begins, the 5-percent ceiling on the value of use of such lodging may not be known until after the beginning of the rental period and thus after the rent for the lodging has been established. The result may be that the rent chosen is below the 5-percent ceiling, which may give rise to income for the individual using the lodging.

The bill modifies the date on which the appraised value is determined in the case of a rental period not greater than 1 year. In such case, the appraised value may be determined at any time during the calendar year in which the rental period begins.

7. Military fringe benefits (sec. 111B(f) of the bill, sec. 1168 of the Reform Act, and sec. 134 of the Code)

Present Law

Under present law, qualified military benefits are excludable from gross income. The term "qualified military benefit" generally means any allowance or in-kind benefit that—

(1) is received by any member or former member of the uniformed services of the United States or any dependent of such

member by reason of such member's status or service as a member of such uniformed services, and

(2) was excludable from gross income on September 9, 1986, under any provision of law or regulation thereunder that was in effect on such date (other than a provision of Title 26).

For purposes of the exclusion of qualified military benefits that are payable in cash, certain adjustments to such benefits after September 9, 1986, are to be disregarded and thus are not to be covered by the section 134 exclusion.

Of course, benefits provided in connection with an individual's status or service as a member of the uniformed services may be excluded from income under other sections of the Code if the requirements for exclusion under such other sections are satisfied, even if such benefit does not qualify as a qualified military benefit.

Explanation of Provision

The bill clarifies that, with respect to the definition of qualified military benefit, the exclusion on September 9, 1986, may have been by administrative practice, in addition to by law or regulation.

The bill also provides that the term "qualified military benefit" does not include personal use of a vehicle. This amendment applies to taxable years beginning after December 31, 1986.

Under the bill, it is further intended that qualified military benefits that are provided in kind may be modified or adjusted after September 9, 1986, without affecting the excludability of such benefit under section 134.

In addition, the bill modifies the general effective date of section 134 to apply to taxable years beginning after December 31, 1984 (rather than beginning after December 31, 1986).

G. Employee Stock Ownership Plans (ESOPs)

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan under which employer stock is held for the benefit of employees. The stock, which is held by 1 or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts) that is exempt under section 4975. An ESOP is required to be designed to be invested primarily in employer securities.

1. Changes in qualification requirements relating to ESOPs (sec. 111B(i), (j), and (k) of the bill, secs. 1174-1176 and 1854 of the Reform Act, and secs. 401, 415, and 409 of the Code)

a. Diversification of investments

Present Law

The Act requires an ESOP to offer a partial diversification election to participants who meet certain age and participation requirements (qualified participants). Under the Act, a qualified participant is entitled annually during any diversification election period following each plan year in the participant's qualified election period to direct diversification of up to 25 percent of the participant's account balance (50 percent in the last election period).

Under the Act, an ESOP is required to provide an annual diversification election period for the 90-day period following the close of the ESOP plan year. Thus, for 90 days after the end of a plan year, an ESOP is to permit an election by those qualified participants who become or remain eligible to make a diversification election during the plan year. Under the Act, any participant who has attained at least age 55 and completed at least 10 years of participation in the plan is a qualified participant. For purposes of the 10-year rule, participation in a predecessor plan is taken into account.

A qualified participant may modify, revoke, or make a new election at any time during the 90-day election period. Any qualified participant is permitted to make a diversification election during each diversification election period following each plan year in the participant's qualified election period.

No later than 90 days after the close of the election period, the plan is to complete diversification pursuant to participant elections. The diversification requirement can be satisfied by (1) offering to distribute to the participant an amount equal to the amount for which the participant elected diversification, (2) substituting for the amount of the employer securities for which the participant elected diversification an equivalent amount of other assets, in accordance with the participant's investment direction, or (3) providing the participant the option to transfer (in accordance with applicable qualification rules) the portion of the account balance for which diversification is elected into a qualified plan that provides for employee-directed investment and in which the required diversification options are available. The ESOP, or the transferee plan in the case of a transfer described in (3), is to offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary).

Explanation of Provision

In order to conform to Congressional intent, the bill clarifies that a qualified participant's qualified election period generally begins with the plan year during which the participant attains age 55 and ends with the fifth succeeding plan year. If, however, the participant has not completed 10 years of plan participation by the end of the plan year in which the participant attains age 55, the qualified election period begins with the plan year in which the participant completes 10 years of plan participation and ends with the fifth succeeding plan year.

For example, in the case of an ESOP using the calendar year as the plan year, a participant who completes 10 years of plan participation before attaining age 55 and who attains age 55 in 1990, becomes a qualified participant in the plan year beginning January 1, 1990. That participant is eligible to direct diversification during the 90-day election period beginning January 1, 1991, and remains eligible to direct diversification during the annual election periods in 1992, 1993, 1994, 1995, and 1996.

Similarly, if the participant completes 10 years of participation in 1990 when the participant is 58, the participant becomes a qualified participant in the plan year beginning January 1, 1990. The participant is eligible to direct diversification during the election periods in 1991, 1992, 1993, 1994, 1995, and 1996.

Under the bill, the qualified election period of any participant does not begin before the first plan year beginning after December 31, 1986. Thus, for example, under the bill, if a participant in a calendar year ESOP attained age 55 and had 10 years of plan participation in 1986, the participant is eligible to make a diversification election during the election periods in 1988, 1989, 1990, 1991, 1992, and 1993.

It is understood that some plans already may have provided for diversification elections in 1988, whereas some plans may not have done so pending the enactment of this bill or the issuance of guidance by the Secretary. Accordingly, the Secretary may provide flexibility with respect to diversification elections in 1988 by, for example, permitting plans to comply with the diversification rules within a certain period following the issuance of guidance by the Secretary.

The bill also clarifies that diversification is to be completed no later than 90 days after the close of the election period, regardless of the method used to implement diversification elections. Thus, diversification is to be completed within the 90-day period regardless of whether diversification is implemented by means of distribution, transfer to another qualified plan which offers the requisite investment options, or reinvestment of employer securities in other assets.

b. Distributions from tax-credit ESOPs

Present Law

An ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability is referred to as a tax-credit ESOP. This credit was initially investment-based (and the plans were called TRASOPs due to their origin in the Tax Reduction Act of 1975), but was payroll-based after 1982 (and the plans were called PAYSOPs). The Act repealed the credit with respect to compensation paid or accrued after December 31, 1986.

Tax-credit ESOPs are subject to the requirements generally applicable to qualified plans and ESOPs. In addition, tax-credit ESOPs are subject to special qualification requirements. In general, under present law, employer securities allocated to an employee's account under a tax-credit ESOP may not be distributed before the end of the 84th month after the month in which the securities were allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or disability, or in the case of certain corporate acquisitions. In addition, under the Act, the 84-month rule does not apply to distributions upon termination of the tax-credit ESOP, effective with respect to plan terminations after December 31, 1984.

Explanation of Provision

The bill clarifies that the exception to the 84-month rule for distributions on termination of a tax-credit ESOP is effective with respect to distributions (rather than plan terminations) occurring after December 31, 1984. This exception is available without regard to whether the employer establishes a successor plan, including an ESOP. The meaning of "termination" and "distribution" for purposes of this rule are to be construed liberally to implement the purposes of the exception, and are not intended to affect the meaning of termination and distribution for other purposes. Thus, for example, a transfer from a tax-credit ESOP to another qualified plan is to be treated as a distribution for purposes of the exception. Of course, any distribution or transfer must comply with any applicable qualification rules. For example, this exception to the 84-month rule does not override the rule requiring consent to distributions if the participant's vested benefits exceed $3,500 (sec. 411(a)(11)).

In order to coordinate the 84-month rule with the new diversification rules, the bill provides that the 84-month rule does not apply to the extent that a distribution is made to satisfy the diversification requirement. This exception to the 84-month rule applies only to the extent that the diversification requirement cannot be satisfied by distributing employer securities that have already met the 84-month rule.

c. Timing of distributions

Present Law

The Act modified the rules relating to the timing and form of required distributions. Under the Act, an ESOP is to permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits under an ESOP is to begin no later than 1 year after the close of the plan year (1) in which the participant separates from service by reason of attainment of normal retirement age under the plan, or (2) that is the fifth plan year following the participant's separation from service for any other reason, unless the participant is reemployed by the employer before such year. The Act provided a special rule with respect to the portion of the participant's account (if any) that consists of securities acquired with an exempt loan.

Unless the participant elects otherwise, distribution is to be made in substantially equal payments (not less frequently than annually) over a period not longer than 5 years. Additional time to distribute the account balance is provided if the balance is greater than $500,000, indexed to take into account increases in the cost-of-living. For 1988, the indexed figure is $522,350. This rule does not preclude more rapid payment.

The rules added by the Act accelerate the otherwise applicable benefit commencement date. Accordingly, if the general rules (secs. 401(a)(9) and 401(a)(14)) require the commencement of distributions at an earlier date, those general rules override the special ESOP rules.

Of course, the special ESOP rules do not permit the employee to elect a form or time of distribution not provided or required to be provided under the plan.

Explanation of Provision

Under the special distribution rule applicable to ESOPs, the bill provides that, in the case of a separation from service for reasons other than separation on or after normal retirement age, death, or disability, distributions are not required to begin if the participant returns to service with the employer prior to the time distribution is otherwise to begin under the rule.

The special ESOP distribution rules create a conflict with the rules added by the Retirement Equity Act of 1984, which provide that benefits in excess of certain amounts cannot be distributed without the consent of the participant (sec. 411(a)(11)), and that, in certain cases, benefits must be paid in the form of a joint and survivor annuity (secs. 401(a)(11) and 417). The bill provides that the provisions of sections 411(a)(11), 401(a)(11) and 417 are controlling. Thus, for example, distribution to a participant cannot commence under the special ESOP rules unless the applicable consent requirements of sections 411(a)(11), 401(a)(11), and 417 are satisfied.

d. Right to demand employer securities

Present Law

A participant in an ESOP who is entitled to a distribution under the plan has the right to demand that the participant's benefits be distributed in the form of employer securities.

Explanation of Provision

To coordinate with the new diversification rules, the bill provides that a participant does not have the right to demand that benefits be paid in the form of employer securities with respect to the portion of the participant's account that the participant elected to diversify.

e. Voting

Present Law

A defined contribution plan (other than a profit-sharing plan) that is established by an employer whose stock is not publicly traded is required to pass through certain voting rights to plan participants if after acquiring securities of the employer more than 10 percent of the total assets of the plan are securities of the employer (sec. 401(a)(22)). Under the Act, the pass-through voting requirement is eliminated with respect to employer securities issued by an employer whose stock is not publicly traded if a substantial portion of the employer's business consists of publishing a newspaper for general circulation on a regular basis.

In addition, all ESOPs are required to pass through certain voting rights to plan participants. The circumstances under which participants are entitled to exercise voting rights depend on whether the employer has a registration-type class of securities. The Act provides that these voting requirements may be satisfied if the plan permits each participant 1 vote with respect to the issue in question and the plan trustee votes the shares held by the plan in the proportion determined by the votes of participants.

Explanation of Provision

The bill incorporates in the statute the provision in the Statement of Managers that the exception to the voting rules applies to an employer (determined without regard to the controlled group rules) whose business consists of publishing a newspaper for general circulation on a regular basis. Thus, the exception does not apply to members of the controlled group that do not meet this requirement.

The bill replaces the term "not publicly traded" in section 401(a)(22) with the term "not readily tradable on an established market" to conform to the term used in section 409. This change is not intended as a substantive change in the rules of section 401(a)(22).

The bill conforms the 1-vote-per-participant rule to the legislative history by providing that it applies only where the employer does not have a registration-type class of securities.

2. Estate tax deduction for sales to an ESOP (sec. 111B(g) of the bill, sec. 1172 of the Reform Act, and secs. 409 and 2057 of the Code)

Present Law

The Act permits a deduction from the gross estate of 50 percent of the qualified proceeds from a qualified sale of employer securities. Under the Act, a qualified sale means any sale of employer securities (within the meaning of sec. 409(1)) by an executor to (1) an ESOP described in section 4975(e)(7), or (2) an eligible worker-owned cooperative (as defined in sec. 1042(c)(2)).

Under the Act, certain penalties apply if any portion of the assets attributable to employer securities acquired in a qualified sale (or assets in lieu thereof) accrue or are allocated during the nonallocation period for the benefit of (1) a decedent whose estate makes such a sale, (2) any person who is related to the decedent in one of the ways described in section 267(b), or (3) any other person who owns (after application of the attribution rules of sec. 318(a) as modified for this purpose) more than (a) 25 percent (by number) of any class of outstanding stock of the corporation (or certain related corporations) that issued such qualified securities, or (b) more than 25 percent of the total value of any class of outstanding stock of the corporation (or certain related corporations).

There are 2 sanctions for failure to comply with the allocation restriction. First, the Act requires that an ESOP that acquires securities in a qualified sale is required to provide that the restriction on the allocation of securities (or assets in lieu thereof) to the sellers, family members, and 25-percent shareholders will be satisfied. Failure to comply with this requirement results in disqualification of the plan with respect to those participants who received prohibited allocations. Thus, failure to comply results in income inclusion for those participants of the value of their prohibited allocations on the date of such allocations. Second, if there is a prohibited allocation or accrual, then a 50-percent excise tax is imposed on the amount involved in the prohibited allocation (sec. 4979A).

Explanation of Provision

The bill conforms the nonallocation rules applicable to sales under section 2057 to the nonallocation rules applicable to sales under section 1042 (relating to nonrecognition treatment for certain sales of stock to an ESOP). With respect to the rule prohibiting allocation or accrual of benefits under a plan attributable to securities acquired in a qualified sale (or assets in lieu of such securities), the bill clarifies that the nonallocation period is the period beginning on the date of the sale and ending on the later of (1) the date that is 10 years after the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.

The bill also provides that individuals who are ineligible to receive an allocation of securities (or other assets) solely because they are lineal descendants of the decedent can receive an allocation of the securities acquired in a qualified sale provided that the total amount of such securities (or assets in lieu thereof) allocated to all such lineal descendants is not more than 5 percent of all employer securities acquired in the decedent's qualified sale.

Finally, the bill clarifies that, in the case of a plan that fails to comply with the nonallocation rules, the statutory period for the assessment of the excise tax imposed with respect to such failure (sec. 4979A) is extended.

3. Partial exclusion of interest earned on ESOP loans (sec. 111B(h) of the bill, sec. 1173 of the Reform Act, and sec. 133 of the Code)

Present Law

In general

Under present law, a bank, an insurance company, regulated investment company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan. A "securities acquisition loan" is generally defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(1)) for the ESOP. There has been some uncertainty as to the availability of the partial interest exclusion with respect to refinancings of the various types of securities acquisition loans.

Back-to-back loans

The Act clarified the definition of a securities acquisition loan in the case of a loan to a corporation with a corresponding loan to an ESOP that is exempt under section 4975 (a back-to-back loan). The Act provides that a loan to a sponsoring corporation will qualify as a securities acquisition loan if the terms of such loan are substantially similar to the terms of the corresponding exempt loan from the corporation to the ESOP. In addition, the Act provides that, if the terms of the 2 loans are not substantially similar, the loan to the sponsoring corporation will still qualify as a securities acquisition loan if (1) the corresponding loan to the ESOP provides for more rapid payment of principal or interest than the loan to the sponsoring corporation; (2) the allocations of stock within the ESOP attributable to the difference in payment schedules do not result in discrimination in favor of highly compensated employees; and (3) the total commitment period of the loan to the sponsoring corporation is not more than 7 years.

The 7-year limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan.

The 7-year limitation on the term of the loan does not apply to loans directly from a commercial lender to an ESOP or to back-to-back loans if the terms of the loans are substantially similar. For example, assume a bank makes a loan to employer X with a term of 10 years and employer X in turn makes a loan to its ESOP. If the terms of the 2 loans are substantially similar, then the partial interest exclusion is available for the entire 10-year commitment period of the loan. Similarly, the partial interest exclusion applies for the entire commitment period of the loan if the loan is made directly from the bank to the ESOP.

Immediate allocation loans

The Act extended the definition of "securities acquisition loan" to include certain loans to a corporation that are used by the corporation to purchase employer securities that are immediately allocated to employees' accounts. Thus, the partial exclusion is available with respect to interest paid on a loan to a corporation to the extent that (1) within 30 days of the date of the loan, employer securities are transferred to the ESOP in an amount equal to the proceeds of the loan, (2) such contributions are allocable to accounts of plan participants within 1 year of the date of the loan, and (3) the total commitment period of the loan does not exceed 7 years.

As in the case of other loans to which the 7-year limitation applies, the limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan.

Refinancings

The Act provided that, in certain cases, the refinancing of a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar, which are discussed above) may also qualify as a securities acquisition loan.

All refinancings, including refinancings of back-to-back loans that are not substantially similar, are required to comply with section 4975.

Explanation of Provision

In general

The bill clarifies the availability of the partial interest exclusion in the case of refinancings of the various types of securities acquisition loans.

Back-to-back loans

The bill provides that, with respect to back-to-back loans the terms of which are not substantially similar, if the total commitment period of the loan is extended beyond 7 years, the partial exclusion will be available, but for the first 7 years of the loan only. This 7-year period begins as of the date of the original loan. The provision is effective with respect to a loan used to acquire employer securities after July 18, 1984, and a loan made after July 18, 1984, that is used (or is part of a series of loans used) to refinance a loan that (1) was used to acquire employer securities after July 18, 1984, and (2) met the requirements of section 133 as in effect at the time the loan was made.

Immediate allocation loans

The bill provides that, with respect to immediate allocation loans, if the total commitment period is extended beyond 7 years, the partial interest exclusion will be available, but for the first 7 years of the loan only. This 7-year period begins as of the date of the original loan. This provision is effective as if included in the Act.

Refinancings

The bill provides that a loan to an ESOP (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) after July 18, 1984, that is used (or is part of a series of loans used) to refinance a loan will qualify as a securities acquisition loan provided that (1) the original loan met the requirements of section 133 as in effect on the date of the loan, or, if later, July 19, 1984; and (2) the original loan was used to acquire employer securities after May 23, 1984. Immediate allocation loans and back-to-back loans that have terms that are not substantially similar are described above.

Under the bill, if a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) is refinanced and as a result the total commitment period exceeds the greater of the original commitment period or 7 years, then the partial exclusion would continue to apply, but only during the first 7 years of the commitment period (measured from the date of the original loan) or the original commitment period, whichever is greater. For example, if an otherwise qualified securities acquisition loan to an ESOP with an original commitment period of 5 years is refinanced and the commitment period is extended for 2 years (for a total commitment period of 7 years), the partial exclusion would apply during the entire 7 years of the loan.

Under the bill, as under the Act, if the terms of the back-to-back loans are no longer substantially similar as a result of the refinancing, the partial exclusion would be available only during the first 7 years of the loan.

4. Sales of stock to an ESOP (sec. 118(s)(4) of the bill, sec. 1854 of the Reform Act, and secs. 404, 409, and 1042 of the Code)

Present Law

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an ESOP or to an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period (sec. 1042).

Prior to the Act, nonrecognition treatment was not available if any portion of the assets attributable to employer securities acquired in a qualified sale (or assets in lieu thereof) accrued or were allocated during the nonallocation period for the benefit of (1) the taxpayer involved in the nonrecognition transaction, (2) any member of the taxpayer's family (within the meaning of sec. 267(b)), or (3) any other person who owned (after application of the sec. 318 attribution rules) more than 25 percent in value of any class of outstanding securities. Temporary Treasury regulations provided that, for purposes of determining whether an individual is a 25-percent shareholder, stock that is owned directly or indirectly by or for a qualified plan is not treated as outstanding (Temp. Treas. reg. sec. 1042-1T Q&A 2(a)(3)).

The Act made several changes with respect to the nonallocation requirement. In particular, for purposes of determining whether an individual is a 25-percent shareholder, the Act provides that the allocation rules of section 318(a) are applied without regard to the employee trust exception in paragraph (2)(B)(i). Thus, all allocated securities held by an ESOP are treated as securities owned by the ESOP participant and are also treated as outstanding securities. This provision is effective with respect to sales of securities after October 22, 1986.

An excise tax is imposed with respect to certain dispositions of employer securities within 3 years of the date of a sale to which section 1042 applies (sec. 4978).

Explanation of Provision

In order to conform the statute to Congressional intent, the bill clarifies that the nonallocation period is the period beginning on the date of the sale and ending on the later of (1) the date that is 10 years after the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.

In some situations, the rules for determining whether an individual is a 25 percent shareholder may be more favorable under the Act than under prior law. The provision of the Act, however, is effective prospectively only. The bill provides that, for purposes of determining whether an individual is a 25-percent shareholder with respect to sales occurring before October 22, 1986, in taxable years beginning after July 18, 1984, all allocated securities held by qualified plans may be treated as outstanding with respect to the individual if securities allocated to the individual under the qualified plans are treated as securities owned by the individual. This rule applies consistently to all individuals with respect to any sales to which section 1042 applies.

The bill provides that the excise tax on certain distributions (sec. 4978) does not apply to employer securities which are required to be disposed of pursuant to the new diversification rules.

5. Dividends paid deduction (sec. 111B(h) of the bill, sec. 1173 of the Reform Act, and sec. 404(k) of the Code)

Present Law

Subject to certain requirements, an employer may deduct dividends paid in cash on employer stock held by an ESOP if, in accordance with the plan provisions, (1) the dividend is paid in cash to the plan participants or their beneficiaries, (2) the dividend is paid to the plan and distributed to participants or beneficiaries not later than 90 days after the close of the plan year in which paid, or

(3) the dividend with respect to employer securities is used to make payments on a loan described in section 404(a)(9) (sec. 404(k)).

Explanation of Provision

The bill provides that, with respect to dividends used to make payments on a loan described in section 404(a)(9), the dividend deduction is available with respect to dividends on both unallocated and allocated ESOP securities. However, dividends on allocated ESOP securities may be used to make payments on such a loan only if the account to which the dividend would have been allocated is allocated employer securities with a fair market value not less than the amount of the dividend that would have been allocated. In addition, such allocation is required to be made in the year the dividend would otherwise have been allocated.

The bill also provides that use of dividends to repay an acquisition loan in accordance with section 404(k) does not violate the prohibited transaction rules of section 4975(d)(3).

H. Technical Corrections to the Retirement Equity Act of 1984 (sec. 118(s)(8) of the bill, sec. 1898 of the Reform Act, secs.414(p), 417, 2039 and 2517 of the Code, and sec. 205 of ERISA)

Present Law

Under present law, a plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. Under the Act, the period during which notice is required to be provided to an individual is the latest of the following periods: (1) the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35; (2) a reasonable period of time after the individual becomes a plan participant; (3) a reasonable period of time after the survivor benefit applicable to a participant is no longer subsidized (as defined in sec. 417(a)(4)); (4) a reasonable period of time after the survivor benefit provisions (sec. 401(a)(11)) become applicable with respect to a participant; or (5) a reasonable period after separation from service in the case of a participant who separates from service before attaining age 35.

The Code provides rules with respect to procedures applicable to and taxation of benefits under qualified domestic relations orders (QDROs). The QDRO rules do not apply to plans that are not subject to the assignment or alienation restrictions of the Code and, therefore, do not apply to governmental plans or to tax-sheltered annuities (sec. 403(b)).

Explanation of Provision

The bill clarifies that the notice period in the case of a participant who separates from service before age 35 overrides any other period during which notice might be required. In such a case, the bill provides that the notification period is a reasonable period after separation from service and such notice period is not included in the list of notice periods the last of which applies.

This provision is effective for distributions after the date of enactment of the bill.

The bill provides that the QDRO rules, including the rules relating to taxation of distributions pursuant to a QDRO, apply to tax-sheltered annuities except as provided in regulations. This extension of application of the QDRO rules will provide more certainty with respect to treatment of domestic relations orders and will provide for uniform tax treatment of such orders with respect to qualified plans and tax-sheltered annuities. Because the nonalienation provision of the Code do not apply to tax-sheltered annuities, it may be appropriate for the Secretary to exempt such annuities from some of the procedural requirements applicable to QDRO's.

I. Other Technical Corrections

1. Health care continuation (sec. 118(s)(7) of the bill, sec. 1895 of the Reform Act, sec. 162(k) of the Code, secs. 602 and 607 of ERISA, and secs. 2202 and 2208 of the Public Health Service Act)

a. Covered employees

Present Law

The health care continuation rules generally require that employers provide qualified beneficiaries with the opportunity to continue to participate for a specified period in the employer's health plan despite the occurrence of a qualifying event that otherwise would have terminated such participation. In general, qualified beneficiaries are defined to include certain "covered employees" and certain family members of covered employees.

Explanation of Provision

Under the bill, the definition of covered employee includes any individual who is (or was) provided coverage under a group health plan by virtue of the performance of services by the individual for 1 or more persons maintaining the plan. Thus, the term "covered employee" can include an individual by virtue of the individual's performance of services as, for example, an independent contractor for a third party or as a partner for his or her partnership.

Pursuant to this provision, for purposes of the health care continuation rules, references to employer or employee in the statute are considered to include persons receiving or performing services other than in an employer-employee relationship. In addition, persons receiving services are subject to the employer aggregation rules of section 414(t) and the employee leasing rules of section 414(n) to the same extent as if such persons were employers with respect to the service performer.

This provision applies to plan years beginning after December 31, 1988. Of course, this provision does not apply to a plan prior to the date that the health care continuation rules generally apply to the plan.

b. New coverage

Present Law

Under the health care continuation rules, continuation coverage provided may be terminated upon the occurrence of certain events. One such event is the coverage of the qualified beneficiary under the group health plan of an employer other than the employer providing the continuation coverage.

Explanation of Provision

The bill deletes the provision allowing continuation coverage to be terminated upon the coverage of the qualified beneficiary under the group health plan of an employer other than the employer providing the continuation coverage.

This provision is intended to carry out the purpose of the health care continuation rules, which was to reduce the extent to which certain events, such as the loss of one's job, could create a significant gap in health coverage. If a qualified beneficiary receiving group health coverage from another employer is willing to pay up to 102 percent of the applicable premium for continuation coverage (which he or she may be required to pay by the employer providing the continuation coverge), this is a strong indication that the new employer group health coverage has left a significant gap in the qualified beneficiary's health coverage. This is especially true when the new employer group health coverage excludes coverage for a preexisting condition that is covered by the continuation coverage.

This provision applies to plan years beginning after December 31, 1988. Of course, this provision does not apply to a plan prior to the date that the health care continuation rules generally apply to the plan.

c. Payment

Present Law

Under the health care continuation rules, if a qualified beneficiary elects continuation coverage under a plan, the plan is to permit payment for continuation coverage during the period preceding the election to be made within 45 days of the date of the election.

Explanation of Provision

The bill clarifies that the plan may not require any payment of any premium for any period of continuation coverage before the day that is 45 days after the day on which the qualified beneficiary made the initial election of continuation coverage.

2. Miscellaneous pension technical corrections (sec. 203(e) of the bill, sec. 9202 of the Omnibus Budget Reconciliation Act of 1986, and sec. 411(a)(8) of the Code)

Present Law

Under present law, for purposes of the qualified plan rules, the term "normal retirement age" means the earlier of (1) normal retirement age under the plan, or (2) the latest of (a) age 65, (b) in the case of a participant who commences participation in the plan within 5 years before attaining normal retirement age under the plan, the 5th anniversary of the commencement of participation, or (c) in the case of a participant not described in (b), the 10th anniversary of the commencement of participation.

Explanation of Provision

Under the bill, normal retirement age is defined to mean the later of (1) age 65, or (2) the 5th anniversary of the time a plan participant commenced participation in the plan.

XII. FOREIGN TAX PROVISIONS (SEC. 112 OF THE BILL)

A. Foreign Tax Credit (sec. 112(a)-(c) of the bill, secs. 1201, 1202, and 1203 of the Reform Act, and secs. 404A, 864, 902, and 904 of the Code)

Under the foreign tax credit system, the United States reserves the right to collect full U.S. income tax on U.S. persons' foreign income, less a limited amount of foreign income tax imposed on that income. The mechanics of the foreign tax credit are such that the United States may collect little or no residual U.S. tax—after aggregate foreign taxes are credited—on income that is taxed abroad at below the U.S. rate. This results where the law permits a cross-crediting of taxes, sometimes referred to as "averaging": that is, where taxpayers are permitted to credit high foreign taxes paid on one stream of income against the residual U.S. tax otherwise due on other, lightly taxed foreign income.

While the Code does not eliminate all cross-crediting among types of differently taxed income, it has in the past separated types of income for credit purposes, most recently based on the character, rather than the country of origin, of income. The Act further separated certain income into the following newly defined "baskets": passive income, high withholding tax interest, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation.

1. Separate application of foreign tax credit provisions to financial services income

Present Law

The "predominantly engaged" test and the priority of the financial services income basket

The financial services income basket applies not only to income earned by an entity predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, but also to income earned by a person in the active conduct of a banking, financing, or similar business, or earned in connection with certain insurance activities, even if that person is not predominantly so engaged. The types of income that the Act places in the financial services income basket of a "predominantly engaged" entity are not limited to the types of income included in the financial services basket of a person not predominantly engaged. For example, income that would otherwise be passive is treated as financial services income in the hands of a predominantly engaged entity, but remains passive in the hands of an entity that is not predominantly engaged.

On the other hand, Congress intended that dividends from each noncontrolled section 902 corporation would be subject to their own separate limitation regardless of whether those dividends also met the definition of financial services income (or of passive income or shipping income or of any other separate limitation type of income).

Generally, the Act places certain export financing interest in the overall limitation basket, that is, outside the separately defined limitation baskets, regardless of whether the entity deriving the interest is engaged in financial services. In addition, the financial services income basket excludes high withholding tax interest. Where a predominantly engaged entity earns interest qualifying as export financing interest that is subject to a 5-percent or greater gross basis tax, however, Congress intended that such interest be treated as financial services income.

Modification of the look-through rule to prevent avoidance of the purpose of the separate limitations

Under the Act's look-through provisions for characterizing certain types of income that a U.S. shareholder derives from a controlled foreign corporation, interest income of the shareholder is generally to be treated as financial services income (without regard to high withholding taxes or other circumstances that would ordinarily shift such interest out of the shareholder's financial services income basket) to the extent that the interest payment is properly allocable to financial services income of the controlled foreign corporation. At the same time, the Act requires the IRS to prescribe such regulations as may be necessary or appropriate to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. In granting this regulatory authority Congress intended that the IRS invoke it to modify, in some cases, the application of the look-through rule.

For example, if a U.S. person lends funds directly to an unrelated foreign person whose country of residence imposes a withholding tax of at least 5 percent on the interest paid on the loan, then the interest is high withholding tax interest subject to the separate limitation for such interest. United States banks might take the position, however, relying upon the look-through rule for interest, that they can avoid the separate limitation for high withholding tax interest by lending funds to such a borrower through a subsidiary that is a controlled foreign corporation incorporated in the borrower's country, rather than lending those funds directly. Taxpayers might argue that, under the look-through rule for interest, interest received in turn by the U.S. bank from the foreign subsidiary will not be high withholding tax interest, even though it attracts the foreign country's high withholding tax.

Because such a result would undermine the separate limitation for high withholding interest, Congress intended that it be precluded under the anti-avoidance regulations. It was expected that such regulations might treat the interest received by the U.S. bank from the foreign subsidiary in this example as high withholding tax interest.

Overall basket treatment of highly taxed financial services income of a controlled foreign corporation

Where the taxpayer establishes to the satisfaction of the Secretary, pursuant to Code section 954(b)(4), that income of a controlled foreign corporation was taxed at over 90 percent of the maximum federal rate, the Act provides that dividends paid by the controlled foreign corporation out of its financial services income (as well as dividends paid out of the controlled foreign corporation's passive income and shipping income) are to be treated as overall basket income to the taxpayer.

Explanation of Provision

The predominantly engaged test and the priority of the financial services income basket

Under the bill only income of persons predominantly engaged in the active conduct of a banking, insurance, financing, or similar business is treated as financial services income. The bill therefore simplifies the foreign tax credit somewhat, relieving taxpayers from the necessity of computing a separate limitation with respect to a very limited type of income (i.e., non-passive, financial services income of an entity not predominantly engaged in providing such services).

The bill clarifies that dividends from a noncontrolled section 902 corporation which would otherwise meet the definition of financial services income are placed in the separate basket for that corporation's dividends. Thus the bill prevents banks and other financial businesses from receiving unintended relief from the 902 basket provisions not available to non-financial businesses.

Where a predominantly engaged U.S. person earns export financing interest (as defined by the Act) that is subject to a 5-percent or greater gross basis tax, the bill clarifies that this interest is financial services income, rather than overall limitation income. In general, this treatment makes it clear that the Code allows cross-crediting of high taxes on such income against U.S. tax on lower-taxed financial services income, supplementing the favored treatment provided in the Act that allows cross-crediting of high taxes on overall basket income against U.S. tax on lower-taxed export financing interest.

Modification of the look-through rule to prevent avoidance of the purpose of the separate limitations

The bill partially eliminates the look-through treatment of interest subject to 5-percent or greater gross basis tax that is paid to a U.S. shareholder by a controlled foreign corporation out of income that would otherwise be treated under the look-through rules as financial services income. In these circumstances look-through treatment would apply only to that portion of the interest payments that exceed the payor's interest income (or its equivalent) that would be treated as financial services income under the look-through rule. This provision makes it clear that lenders are prevented from shifting high withholding tax interest into the financial services basket by the mere interposition of a controlled local entity between themselves and foreign borrowers. At the same time, however, if a controlled foreign corporation's interest payments to its U.S. shareholder are subject to a 5-percent or more gross-basis tax, and they exceed by, for example, $100 the foreign corporation's interest income (or its equivalent) that would, under a look-through approach, be treated at the U.S. shareholder level as financial services income, then the U.S. shareholder would be afforded look-through treatment on that $100 of interest received from the subsidiary.

Overall basket treatment of highly taxed financial services income of a controlled foreign corporation

The bill provides for separate basket treatment of dividends paid by controlled foreign corporations where paid out of the latter's financial services income (or shipping income), even where it has been established pursuant to section 954(b)(4) that the controlled foreign corporation's income was taxed by a foreign government at more than 90 percent of the maximum U.S. rate. Thus, for example, a dividend from a highly taxed banking subsidiary will be available for cross-crediting against U.S. tax on other lower-taxed financial services income of the parent.

2. Shipping income

Present Law

The Act establishes a separate foreign tax credit limitation for shipping income. This limitation applies to income received or accrued by any person which is of a kind that would be foreign base company shipping income under Code sec. 954(f). The Act did not provide express ordering rules to determine the correct basket for income that could be placed in the shipping basket or a basket for dividends from a noncontrolled section 902 corporation. However, as indicated above, Congress intended the baskets for section 902 corporations to take priority over the shipping basket.

As in the case of financial services income described above, where the taxpayer establishes to the satisfaction of the Secretary that income of a controlled foreign corporation was taxed at over 90 percent of the maximum federal rate, the Act provides that dividends paid by the controlled foreign corporation out of its shipping income are to be treated as overall basket income to the taxpayer.

Explanation of Provision

The bill provides that dividends from a noncontrolled section 902 corporation that might otherwise constitute shipping income are to be placed in that corporation's dividend basket rather than the shipping basket, consistent with Congress' intent generally to give first priority to the section 902 dividend baskets.

As in the case of financial services income, the bill provides for separate basket treatment of dividends paid by a controlled foreign corporation out of its shipping income when the taxpayer established to the satisfaction of the Secretary that the income was taxed by a foreign government at more than 90 percent of the maximum U.S. rate. Thus, taxpayers may cross-credit taxes on any highly taxed shipping income against the U.S. tax on other shipping income they may earn.

3. High withholding tax interest

Present Law

Definition of high withholding tax interest

The Act defines high withholding tax interest generally as any interest (other than export financing interest) subject to a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more. The Act further states that the Secretary may by regulations provide that amounts (not otherwise high withholding tax interest) will be treated as high withholding tax interest where necessary to prevent avoidance of the purposes of the separate limitations. Congress intended these rules to encompass foreign gross-basis taxes and other taxes that are substantially similar in the sense that their imposition results in heavier taxation by the levying country of foreign lenders than of residents.

Transition rule for high withholding tax interest on qualified loans

Generally for taxable years beginning after December 31, 1986, interest income subject to a foreign withholding tax or other gross basis tax of 5 percent or more (other than export financing interest) is "high withholding tax interest" subject to its own separate foreign tax credit treatment. A special transition rule applies, however, to certain interest on certain loans to any of 33 foreign countries or to any resident of one of those countries for use in that country. The applicability of the transition rule turns on the amount of loans held by the taxpayer on November 16, 1985 and during subsequent taxable years.

Explanation of Provision

Definition of high withholding tax interest

The bill gives the Secretary authority to exclude from the definition of withholding taxes, for these purposes, those taxes that are in the nature of a prepayment of a tax imposed on a net basis, where the tax in question is otherwise free of those characteristics of a gross-basis tax that would warrant treatment as high withholding taxes. Thus, the bill makes clear that where a foreign taxing authority uses withholding simply as a collection mechanism (as does the United States in the cases of ordinary wage withholding and backup withholding on certain interest, dividend, and other reportable payments under Code section 3406), it will not necessarily follow that the mechanism results in interest being treated as high withholding tax interest.

Transition rule for high withholding tax interest on qualified loans

The bill provides that for purposes of this transition rule, all members of an affiliated group of corporations filing a consolidated return shall be treated as one corporation. (Under this rule, intercompany loans are eliminated.) Thus, for members of a consolidated group, the transition relief will be available regardless of and will be limited without regard to, the particular group member holding qualified loans on November 16, 1985, or during the relevant subsequent taxable year.

4. Passive income

Present Law

Related party factoring income

Under the related party factoring rules of the Tax Reform Act of 1984, any income of a controlled foreign corporation from a loan to a person for the purpose of financing the purchase of inventory property of a related person was interest for separate foreign tax credit limitation purposes without regard to the exceptions to prior law's separate limitation for interest. Under the 1986 Act, such income of a controlled foreign corporation is also ineligible for the export financing exception to the new separate limitations (sec. 864(d)(5)(A)(i)). In the case of passive income, this result follows because the Act defines passive income generally as income "of a kind which would be foreign personal holding company income" (Code sec. 904(d)(2)(A)(i)); if export financing interest fits that description, the related party factoring rules make unavailable the export financing exception from passive basket treatment which would otherwise be available.

Congress did not intend that the availability of the export financing exception for interest received directly by U.S. persons (rather than by controlled foreign corporations) be restricted by the 1984 factoring rule governing loans made to finance inventory property purchases, or by the analogous 1986 rule. However, the phrase "of a kind which would be foreign personal holding company income" arguably leads to an inference that interest income earned directly by U.S. persons (i.e., interest that would be foreign personal holding company income if the recipient was a controlled foreign corporation) is ineligible for overall basket treatment under the export financing exceptions.

Income inclusions under sections 551 and 1293

Foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under new Code sec. 1293) are passive income. In the case of a passive foreign investment company inclusion, Congress intended that the high-tax kick-out shift the inclusion to the overall limitation basket, however, if the creditable foreign tax with respect to the inclusion exceeds the U.S. tax on the inclusion.

Explanation of Provision

Related party factoring income

The bill clarifies that in determining whether income is "of a kind which would be foreign personal holding company income" the related person factoring rules applicable to controlled foreign corporations shall apply only in the case of an actual controlled foreign corporation. Thus, income earned directly by a U.S. person may be eligible for the applicable export financing exceptions.

Income inclusions under sections 551 and 1293

The bill clarifies that income inclusions under section 1293 are subject to recharacterization (e.g., by virtue of the high-tax kick-out), as are other kinds of income generally categorized as passive.

5. Dividends from noncontrolled section 902 corporations

Present Law

The Act defines "dividends from each noncontrolled section 902 corporation" and subjects them to separate foreign tax credit limitations. Congress intended that these separate limitations would govern only those taxpayers that might, by virtue of the dividends, be entitled to deemed paid foreign tax credits. Generally under present and prior law, only a corporate taxpayer whose stock holdings in the dividend payor meet a 10 percent threshold can be entitled to a deemed paid credit on the dividend.

Dividends from a controlled foreign corporation are not subject to the separate limitation when the former come from income the corporation earned *as* a controlled foreign corporation. Generally, Congress intended the look-through rules for distributions by controlled foreign corporations to apply to those dividends.

Explanation of Provisions

The bill clarifies that any taxpayer that is not a corporation, and thus is not eligible to receive deemed paid credits on dividends from a foreign corporation, is not subject to the separate limitations for dividends from noncontrolled section 902 corporations.

The bill also provides that dividends from a controlled foreign corporation, out of earnings for periods during which the dividend recipient was not a U.S. shareholder with respect to the corporation, will be treated as dividends from a noncontrolled section 902 corporation. Thus, the bill implements the Act's policy of preventing cross-crediting of taxes between income earned by a taxpayer and income derived by an entity within which the taxpayer does not hold a majority interest, either alone or in combination with other U.S. shareholders. For example, a U.S. person that becomes a U.S. shareholder of a controlled foreign corporation cannot use the look-through rule to cross-credit foreign taxes paid (or deemed paid) by the corporation prior to the taxpayer's stock ownership against U.S. tax on the taxpayer's other income. Nor can the taxpayer cross-credit foreign withholding taxes paid on dividends out of earnings from the pre-ownership period against U.S. taxes on income other than dividends from that corporation. By the same token, the taxpayer cannot credit its other foreign taxes against U.S. tax on those dividends.

6. Separate application of foreign tax credit limitation to income of controlled foreign corporations under the look-through rules in general

Present Law

Payments by controlled foreign corporations to U.S. shareholders

A payment of interest, rent, or a royalty is ordinarily characterized as separate or overall limitation income under the general rules defining the new separate limitation categories (sec. 904(d)(2)). Under the look-through rules of new Code section 904(d)(3), however, any interest, rent, or royalty which is received or accrued from a controlled foreign corporation by a U.S. shareholder will be treated as separate category income to the extent it is properly allocable to separate category income of the controlled foreign corporation.

Without a mechanism to determine which set of rules takes precedence, the application of the look-through rules, on the one hand, and the general definitions of 904(d)(2), on the other, could produce conflicting results. For example, interest paid to a U.S. shareholder by a controlled foreign corporation earning only overall limitation income may be subject to a high withholding tax. Also, interest may be paid by a controlled foreign corporation to its U.S. shareholder to finance sales by the U.S. shareholder. On the one hand, this interest may qualify as export finance interest; on the other hand, the interest may be properly allocable to the controlled foreign corporation's income unrelated to export financing.

Congress intended that the question whether interest received from a controlled foreign corporation by a U.S. shareholder of the corporation is overall limitation income or a separate limitation type of income generally depend upon the look-through rules, not upon whether the payment was made to finance an export or upon whether the payment bore a high withholding tax. In the case of high withholding tax interest, Congress expected the IRS to promulgate regulations specifying circumstances where it might be necessary to reverse the priority of the look-through rule in order to forestall abuse of the separate basket rules, as described above.

Under the high-tax kick-out of section 904, the passive income basket generally excludes high-taxed income, that is, income subject to foreign taxes paid or deemed paid by the taxpayer at rates higher than the maximum federal rates. As with financial services income and shipping income discussed above, the Act provides that for purposes of applying the dividend look-through rule, income that would otherwise be passive basket income will instead go into the overall limitation basket if shown to be subject to an effective foreign tax rate greater than 90 percent of the maximum federal tax rate.

In the case of payments of interest, rents, and royalties to the U.S. shareholder out of income of a controlled foreign corporation that would otherwise be passive, the combined effect of the look-through and high-tax kick-out rules may have been unclear.

De minimis exception

If a controlled foreign corporation has no foreign base company income or subpart F insurance income in a taxable year because the subpart F de minimis rule (Code sec. 954(b)(3)(A), as amended by the Act) is satisfied for that year, then interest, rents, or royalties paid by the corporation during that year and dividends, to the extent treated as paid from that year's earnings and profits, are not treated as income in a separate limitation category.

Explanation of Provision

Payments by controlled foreign corporations to U.S. shareholders

The bill clarifies the Act's general rule that income of a U.S. shareholder allocable to separate category income of a controlled foreign corporation will retain that character in the hands of the U.S. shareholder, subject to the high-tax kick-out (and to another exception, described above, relating to interest paid by a controlled foreign corporation bearing a high withholding tax but attributable to financial services income). For example, the bill makes it explicit that interest that technically may qualify as export financing interest paid by a controlled foreign corporation to a U.S. shareholder out of the corporation's passive income will be in the shareholder's passive basket rather than its overall basket.

The bill makes it clear that the high-tax kick-out applies only at the U.S. shareholder level, not at the controlled foreign corporation level. Income of the U.S. shareholder out of the controlled foreign corporation's passive income will be subject to the kick-out based on the entire amount of foreign tax imposed on the U.S. shareholder's income. Thus, where a withholding tax is imposed on royalties paid by a controlled foreign corporation to a U.S. shareholder out of the corporation's passive income, the shareholder's income will be in the overall basket if the withholding tax is high enough to trigger the high-tax kick-out after allocation of U.S.-borne expenses.

De minimis exception

The bill limits the effect of the provision that treats income satisfying the de minimis rule as non-separate limitation income. Under the bill, this treatment applies only to the controlled foreign corporation's foreign base company income (determined without regard to deductions otherwise taken into account for subpart F purposes under sec. 954(b)(5)) and gross insurance income for the taxable year, as that term is generally used for subpart F purposes.

7. Deemed-paid credit

Present Law

Separate deemed paid foreign tax credit limitations

The Act clarifies that the rules for credits deemed paid on the receipt of dividends (Code sec. 902) and the subpart F deemed-paid credit rules (sec. 960), as well as the general foreign tax credit limitation rules (sec. 904(a)-(c)) and the separate foreign oil and gas limitation rules (sec. 907), apply separately to categories of income subject to the separate limitations. The Act also gives the Secretary authority to provide such regulations as may be necessary or appropriate to carry out both sets of deemed-paid credit rules, but in so doing, refers to specific authority to regulate the separate computation of taxes deemed paid on separate limitation categories of income only in the case of taxes deemed paid on account of dividends.

Fresh start for computing discounted unpaid losses

The Act provides that for purposes of computing the deemed-paid foreign tax credit, dividends or subpart F inclusions are considered made first from the post-1986 pool of all the distributing corporation's accumulated earnings and profits. Act amendments to subchapter L of the Code that limit the unpaid loss deductions of property and casualty insurance companies to the amount of their discounted unpaid losses (new sec. 846 of the Code) may result in a one-time increase in earnings for such a company.

In general, the new discounting provisions apply to taxable years beginning after December 31, 1986. A fresh start is provided with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted loss reserves and the discounted balances is not taken into income. For purposes of calculating any adjustment to earnings and profits, by contrast, the fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply.

Blocked income

In the case of taxes deemed paid under section 902 on dividends, the Act defines the term "post-1986 undistributed earnings" by reference to the definitions of earnings and profits in sections 964 (prescribing rules for the computation of earnings and profits of a foreign corporation) and 986 (prescribing rules for the translation of a foreign corporation's foreign currency denominated earnings into dollars).

Section 964 has three parts. The first part provides generally for the computation of earnings of foreign corporations in a way substantially similar to the earnings of a domestic corporation, with some exceptions. The second part excludes blocked income, for purposes of sections 952, 955, and 956, from earnings and profits of a controlled foreign corporation. Blocked income is income that is shown, to the satisfaction of the Secretary of the Treasury, to be unavailable for distribution by a controlled foreign corporation to United States shareholders due to currency or other restrictions or limitations imposed under the laws of any foreign country. The third part provides record-keeping and record disclosure rules for purposes of enforcing subpart F and subpart G (relating to export trade corporations).

Earnings and profits of corporations with qualified foreign plans

Special rules govern the timing of deductions for contributions to, and additions to reserves for, deferred compensation programs that are "qualified foreign plans" (sec. 404A). A qualified foreign plan is one in which, among other things, 90 percent or more of the amounts annually taken into account are attributable to services performed by individuals who are not citizens or residents of the

United States, the compensation for which is not subject to U.S. Federal income tax (sec. 404A(e)(2)).

Contributions and additions to a qualified foreign plan will typically relate to income subject to foreign taxes on a net basis, and may implicate foreign laws on the timing and amount of deductions with respect to deferred compensation plans, as well as U.S. rules for computing the amounts of foreign tax payments by subsidiaries that are creditable at the shareholder level. Section 404A contains internal limits on annual contributions and additions analogous to the limits governing domestic plans (e.g., secs. 404A(b), (c), (g)(1) and (g)(3)). The deductions allowed by section 404A, however, take into account the interactions between these limits, applicable deduction rules of foreign law, and the Code rules for computing indirect foreign tax credits.

There are two ways in which these interactions determine the deduction under section 404A. The first involves a multiyear comparison between foreign deductions and U.S. limits. The employer computes "the aggregate amount determined with respect to the plan under" section 404A without regard to section 404A(d)(1): generally, the sum of the amounts for each taxable year to which section 404A applies that would not exceed the internal limits of 404A. This is called "the cumulative United States amount." The employer also computes the aggregate amount allowed as a deduction under foreign law for the same period. This is called "the cumulative foreign amount." Then the employer subtracts any prior-year deductions taken under 404A from both the cumulative United States amount and the cumulative foreign amount. The section 404A deduction for the current year generally equals the lesser of the two differences (sec. 404A(d)(1)).

Indirect credits determined by current foreign earnings and taxes

A further limitation can reduce the deduction below the lesser of the above two amounts. This limitation represents the second way in which section 404A takes into account the interaction between the domestic and foreign plan contribution limits and the indirect credit rules. The limitation provides that the deduction allowed in computing the earnings and profits or the accumulated profits of any foreign corporation with respect to a qualified foreign plan is not in any event to exceed the amount allowed as a deduction under the appropriate foreign tax laws for such taxable year (sec. 404A(d)(3)). This limitation was imposed in 1980, simultaneously with the enactment of section 404A, in response to possibilities for distortion of a taxpayer's indirect foreign tax credit which were presented by the annual system, then in effect, for determining the amount of the foreign taxes paid by a subsidiary which were brought up with dividends paid to its U.S. shareholders.

Example 1: Assume that a U.S. corporation has a wholly-owned foreign manufacturing subsidiary that began operations in January 1980 and has no U.S. source or U.S. effectively connected income. Both are on a calendar year taxable year. Suppose 404A first applied to them in taxable year 1980. In that year the foreign corporation had a qualified funded plan and a qualified trust within the meaning of 404A(b). Before pension deductions, the foreign corporation had 100 units of taxable income under the tax laws of its home country in each of the years 1980 and 1981. Not counting income taxes and pension contributions, the foreign corporation's earnings and profits for U.S. tax purposes were the same. The foreign corporation's home country tax rate was 25 percent.

For 1980, assume that the foreign corporation made a 30 unit contribution to the plan, and that the corporation's home country gave it a current deduction for the full contribution. Foreign taxes were thus 17.50. Assume that section 404A(b) (which sets contribution limits analogous to those governing domestic plans) would have allowed only a 20 unit deduction from the foreign corporation's earnings and profits. For U.S. tax purposes, then, the contribution reduced the foreign corporation's earnings and profits by 20 units. Net earnings and profits for 1980 were thus 62.50 (100 minus 20 minus 17.50).

In 1981 assume that the foreign corporation made a 20 unit plan contribution that was again fully deductible currently for foreign law purposes. Assume that 404A(b) would have allowed a 30 unit deduction: 20 for the 1981 contribution plus 10 carried over from 1980 (*see* sec. 404A(b)(4)). Both the cumulative United States amount and the cumulative foreign amount are therefore 50 units. Because the 1980 deduction was 20 units, the difference between either cumulative amount and the prior year deduction is 30 units. Disregarding 404A(d)(3), then, the deduction from earnings and profits under section 404A would be 30 units. In effect, this would represent a carryover of the excess of the 1980 foreign deduction over the 1980 U.S. amount computed under 404A(b). However, if earnings and profits were reduced by a 30 unit pension plan contribution, then under section 902 as in effect for 1981, the foreign corporation could have paid a 50 unit dividend that brought up a 20 unit tax,[1] for an effective creditable foreign tax rate of 28.6 percent. This would have been true even if the 1981 dividend were the first dividend paid by the foreign corporation in the 1980-81 period.

Section 404A(d)(3) was enacted to prevent this result. Under 404A(d)(3), the section 404A deduction for 1981 is limited to 20 units, and a 50 unit dividend out of 1981 earnings would bring up an indirect credit equal to 20 times 50/60, or 16.67 units, for an effective creditable foreign tax rate of 25 percent.

In the 1980-81 period, foreign law allowed a deduction of 50 units, and the limits in 404A(b) would not have been exceeded by a deduction of 50 units. However, for that same period, 404A(d) actually allows a deduction from earnings and profits of only 40 units. There is no mechanism for making up this difference in future years.

Pooling foreign earnings and taxes for indirect credits

In the legislative history of section 404A, Congress noted that the potential for distortion of the indirect credit, to which section 404A(d)(3) was targeted, "might be eliminated if the indirect credit were computed with reference to the subsidiary's accumulated foreign taxes and undistributed accumulated profits for all years." Sen. Rep. No. 1039, 96th Cong., 2d Sess. 15 (1980). In the 1986 Act Congress amended the indirect credit to achieve the type of multiyear pooling referred to in the legislative history of 404A. The indirect credit on distributions by foreign corporations out of earnings and profits for taxable years beginning after 1986 are computed with reference to the post-1986 pool of all the subsidiary's accumulated earnings and profits, and the accumulated foreign taxes paid by the subsidiary on or with respect to the accumulated earnings in the pool. Any dividends paid in the first taxable year beginning after December 31, 1986 (or, if later, the first taxable year beginning after 1986 in which there is a 10-percent U.S. shareholder who would qualify for the deemed-paid credit) and subsequent years are generally treated as made out of the pool of post-1986 undistributed earnings, to the extent thereof.

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[1] Foreign taxes equal 20, or 25 percent of the difference 100 minus 20. Earnings and profits would equal 50, or 100 minus 30 minus foreign taxes. Therefore, a 50 unit dividend would bring up all of the foreign tax.

Example 2: The introduction of pooling changes the deemed-paid credits available from a foreign corporation that maintains a qualified foreign plan and does not distribute all of its earnings currently. For example, assume the same facts as in example 1 above, except that the years 1980-81 are changed to 1990-91. Also assume that there are no distributions in 1990. Before any 1991 distributions, post-1986 undistributed earnings are 122.50 (62.50 units from 1990 and 60 units from 1991). The effective rate of taxes brought up with a 1991 distribution, then, would be about 23.4 percent (i.e., 1990-91 taxes (37.50) divided by 1990-91 earnings grossed up by the taxes (122.50 plus 37.50)). In this case only 112.50 units of earnings are available for distribution assuming that no plan assets revert to the foreign corporation (earnings available for distribution equal 200 minus 37.50 units of tax minus 50 units contributed to the plan). Therefore of the 37.50 units of accumulated 1990-91 taxes, it is only possible for the parent to receive approximately 34 units of foreign tax credits in a distribution of earnings.

Explanation of Provision

Separate deemed paid foreign tax credit limitations

The bill clarifies that the Secretary's authority to provide regulations to carry out the provisions of the subpart F deemed-paid credit rules is to include authority to provide for, inter alia, separate computations of taxes deemed paid upon inclusions under subpart F (as well as separate computations of taxes deemed paid in connection with dividends) to reflect the separate limitations applicable to separate types of income and loss.

Fresh start for computing discounted unpaid losses

The bill provides that any increase in earnings and profits under the discounting fresh start provision of the Act would be phased in ratably over 10 years for purposes of computing the post-1986 undistributed earnings of a foreign corporation paying dividends, or earning income, that bring up to its shareholders deemed-paid foreign tax credits. Thus, the one-time increase in current earnings and profits of a controlled foreign corporation under the discounting fresh start provision will not result in a sudden dilution of creditable foreign taxes as a percentage of dividends and subpart F inclusions.

Blocked income

The bill provides that for purposes of the deemed-paid credit on dividends, "post-1986 undistributed earnings" of a foreign corporation are computed without reference to the blocked income rules. Thus, the bill clarifies that the percentage of foreign taxes brought up by a dividend is unaffected by the portion of earnings, if any, that represent blocked income.

Earnings and profits of corporations with qualified foreign plans

The bill gives the Secretary authority to provide exceptions to section 404A(d)(3) by regulation. It is intended that in the case of earnings to which pooling applies, the deduction from earnings and profits for contributions or additions to reserves under section 404A(d)(1) not be limited by the current foreign law deduction. With respect to pre-1987 earnings and taxes, however, it is intended that existing law continue to apply.

Thus in example 2 above, 1991 earnings and profits of the foreign corporation would would be 50 and post-1986 undistributed earnings would be 112.50. Because post-1986 foreign income taxes are 37.50, any distribution will bring up one-third the net distribution amount in credits, for an effective rate of 25 percent.

Assume, on the other hand, an example involving a U.S. parent and a foreign subsidiary with income and taxes in both 1980-81 and 1990-91, as described in examples 1 and 2, respectively. Assume that the foreign corporation makes no distributions until 1991, when it distributes 162.50. In that case, regulations may provide that the distribution brings up all of the 1990-91 taxes, but it is intended that regulations not allow the shareholder a foreign tax credit for more than 16.67 of the 1980-81 taxes. Thus the distribution out of pre-1987 earnings would bring up the same amount of foreign tax credits as a distribution subject to section 404A as originally enacted, resulting in this case in a 25 percent effective rate for the indirect credits attributable to 1981.

8. Recapture of foreign separate limitation losses

Present Law

The 1986 Act provided express rules to clarify that losses in the new and existing separate limitation baskets do not reduce U.S. taxable income before foreign taxable income (new Code sec. 904(f)(5)). The new rules provide that losses for any taxable year in a separate foreign tax credit limitation basket and in the overall limitation basket offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other baskets. These losses (to the extent that they do not exceed foreign income for the year) are to be allocated on a proportionate basis among (and operate to reduce) the foreign income baskets in which the entity earns income in the loss year.

By analogy to the overall foreign extraction loss recapture rules of section 907(c)(4), the Act further provides a loss recharacterization rule that applies to subsequent income. Where a basket previously showed a separate limitation loss which was allocated against income in other baskets, subsequent income in the loss basket will be recharacterized as income of the type that it previously offset, in proportion to the prior loss allocation not previously taken into account under this recharacterization provision.

In addition to the Act's new separate basket loss recapture provision and the overall foreign extraction loss recapture rules upon which the former is based, the Code provides a third rule, in effect since 1976, for recapture of overall foreign losses. This rule is designed to prevent taxpayers from benefiting from a combination of forgiveness of U.S. tax on a portion of current U.S. income (resulting from the use of an overall foreign loss to reduce worldwide taxable income below U.S. taxable income) and an allowance of a foreign tax credit with respect to the full amount of subsequent years' foreign income. Under the rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (sec. 904(f)(1)-(4)).

Section 904(f)(3) contains gain recognition and characterization rules to ensure the recapture of an overall foreign loss where property which was used in a trade or business, and which was used predominantly outside of the United State, is disposed of prior to the time the loss has been recaptured by recharacterizing foreign income as U.S. taxable income. Under section 904(f)(3), gain on such a disposition is viewed as foreign source income to be recharacterized as U.S. source income until the loss is fully recaptured. Recapture occurs regardless of whether gain would otherwise have been recognized on the disposition. There is no provision analogous to section 904(f)(3) in the recapture rules for foreign oil and gas extraction losses, or in the Act's new separate limitation loss recapture provision.

Explanation of Provision

The bill adds a provision to the Act's separate loss recharacterization rules stating that recognition rules similar to those of section 904(f)(3), applicable to an overall foreign loss, shall apply to any disposition of property, the gain from which would be in an income category whose separate limitation loss was allocated against any separate limitation income. Thus, the bill achieves a result consistent with the general loss recharacterization rules of the Act in the case where losses in a category have been allocated against income in the other categories, and property generating income in the loss category is disposed of at a gain (whether or not the gain would be recognized for other Code purposes) before income in the other categories has been restored to the full extent of losses allocated against them.

9. Transitional rule for excess credit carryforwards

Present Law

Under the Act, foreign tax credit carryforwards allowed for foreign taxes paid in pre-effective date tax years (that is, years beginning before 1987, to which the Act amendments to the foreign tax credit rules generally do not apply) generally reduce the U.S. tax in post-effective date years (that is, years beginning after 1986) on income of the same limitation type as the income on which the carried forward taxes were imposed. For example, the Act provides that foreign tax credit carryforwards of foreign taxes paid in pre-effective date taxable years on income then subject to the overall limitation generally are to reduce the U.S. tax in post-effective date taxable years on overall limitation income as newly defined by the Act. Similarly, carryforwards from the prior law basket for interest are to reduce U.S. tax on post-effective date passive income.

However, the Act provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on shipping income to the extent that the taxpayer establishes to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as shipping income had it been earned after the Act's effective date. Similarly, in the case of an entity predominantly engaged (in both the carry-from and carry-to years) in the active conduct of a banking, insurance, financing, or similar business the Act provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income to the extent that the taxpayer establishes to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as financial services income had it been earned after the Act's effective date.

Explanation of Provisions

The bill provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on high withholding tax interest income to the extent that the taxpayer chooses to and does establish to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as high withholding tax income under the Act's substantive rules (that is, under the Act without regard to the transitional rule for qualified loans, discussed above). For example, a gross basis tax of 5 percent or more, paid by a bank in a pre-effective date year on interest earned in the conduct of its banking business, could be carried forward to reduce residual U.S. taxes (if any) on its post-effective date high withholding tax interest, rather than taxes on income in the overall basket. As another example, the bill would enable a manufacturer with excess post-effective date credits on its foreign manufacturing income, but excess limitation on its high withholding tax interest, to use credit carryforwards for 5 percent or more gross-basis taxes paid on pre-effective date overall basket interest to offset the residual U.S. tax on post-effective date high withholding tax interest.

B. Source Rules

1. Determination of source in case of sales of personal property (sec. 112(d) of the bill, sec. 1211 of the Reform Act, and secs. 864 and 865 of the Code)

Present Law

Overview

Prior to the Act, the source of income derived from the sale of personal property generally was determined by the place of sale (commonly referred to as the "title passage" rule). While the Act did not change the place-of-sale rule for most inventory sales, the Act generally did replace the place-of-sale rule for sales of other personal property with a residence-of-the-seller rule.

Under the residence-of-the-seller rule (new sec. 865), income derived by U.S. residents from the sale of personal property, tangible or intangible, generally is sourced in the United States. Similarly, income derived by a nonresident of the United States from the sale of personal property, tangible or intangible, generally is treated as foreign source. For purposes of determining source, the term sale does not include a sale of intangible property to the extent payments received in consideration for the sale are contingent on the productivity, use, or other disposition of the property. Payments that are so contingent are treated like royalties in determining their source.

Definition of resident

The Act provided new definitions of a U.S. resident and nonresident for source rule purposes (sec. 865) that differ somewhat from the existing resident alien definitions (*see*, *e.g.*, sec. 7701(b)).

An individual is a resident of the United States for purposes of section 865 if the individual has a tax home (as defined in sec. 911(d)(3)) in the United States. Any corporation, partnership, trust, or estate which is a United States person (as defined in sec. 7701(a)(30)) is a U.S. resident for this purpose. Other individuals and entities generally are nonresidents for purposes of these source rules. A U.S. citizen or resident alien can be treated as a nonresident for purposes of these source rules if he or she has a tax home outside the United States. The same individual can also be treated as a nonresident if he or she has no tax home (a condition that might be possible, for example, in the case of a traveling salesperson). This latter result may occur even if the individual pays only a minimal foreign tax on income covered by these source rules.

Under the Act, regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions. One area where it was contemplated that regulations may be required is to prevent persons from establishing partnerships or corporations, for example, to change their residence to take advantage of the new rules. It was anticipated that the establishment of an anti-abuse rule to treat, for example, a foreign partnership as a U.S. resident to the extent its partners are U.S. persons would be appropriate.

United States citizens and resident aliens who have tax homes outside the United States are nevertheless considered U.S. residents in one case. This case occurs when income from a sale is not subject to an effective foreign income tax of 10 percent or more. This level-of-tax rule prevents U.S. citizens and resident aliens from generating zero- or low-taxed foreign source income that might otherwise escape all tax. As a consequence of retaining prior law's place-of-sale rule for income derived from the sale of inventory and gain in excess of recapture derived from the sale of depreciable personal property, the level-of-tax rule does not apply to sales of these types of personal property but does apply to sales of all other types of personal property.

Exceptions to residence rule

Income derived from the sale of depreciable personal property

The residence-of-the-seller rule does not apply to income derived from the sale of depreciable personal property, to the extent of prior depreciation deductions. This income is sourced under a recapture principle. Specifically, gain to the extent of prior depreciation deductions from the sale of depreciable personal property is sourced in the United States if the depreciation deductions giving rise to the gain were previously allocated against U.S. source income. If the deductions giving rise to the gain were previously allocated against foreign source income, gain from the sale (to the extent of prior deductions) is sourced foreign. If personal property is used predominantly in the United States for any taxable year, the taxpayer is to treat the allowable deductions for the year as being allocable entirely against U.S. source income. If personal property is used predominantly outside the United States for any taxable year, the taxpayer is to treat the allowable deductions for such year as being allocable entirely against foreign source income. (This special predominant-use rule does not apply for certain personal property generally used outside the United States, namely, personal property described in sec. 48(a)(2)(B).) These rules apply without regard to the residence of the taxpayer.

Depreciable personal property is any personal property if the adjusted basis of the property includes depreciation adjustments. Thus, intangible property for which an amortization deduction is allowable is considered depreciable personal property. With respect to sales of intangible property, however, it is unclear under the Act whether the recapture rule applies to gain to the extent of amortization recapture, and whether the general intangible rules or the place-of-sale rule as retained under the Act applies to gain in excess of amortization recapture.

Income attributable to an office or other fixed place of business

The residence-of-the-seller rule does not apply to income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business outside the seller's residence.

For U.S. residents, this office rule applies to certain income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business maintained by the taxpayer outside the United States but only if an effective foreign income tax of 10 percent or more is paid to a foreign country on the income from the sale. It is unclear under the Act if the office rule applies to income (in the form of noncontingent payments) derived from the sale of intangible property by a U.S. resident when the sale is attributable to a fixed place of business in a foreign country and the U.S. resident pays an income tax at an effective rate of 10 percent or more.

Income derived from the sale of stock in foreign affiliates

The residence-of-the-seller rule does not apply to income derived by U.S. corporations from the sale of stock in certain foreign affiliates. If a U.S. corporation sells stock of a foreign affiliate in the foreign country in which the affiliate derived from the active conduct of a trade or business more than 50 percent of its gross income for the 3-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurs, any gain from the sale is foreign source. An affiliate, for this purpose, is any foreign corporation whose stock is at least 80 percent owned (by both voting power and value). It is unclear under the Act if this rule applies only to gain from the sale of stock in corporations directly engaged in an active trade or business or also applies to gain from the sale of stock in corporations indirectly engaged in an active trade or business (for example, through a locally incorporated subsidiary).

Other rules

Prior to the Act, foreign source income derived from the sale of inventory property by a foreign person generally was treated as effectively connected with the conduct of a U.S. trade or business if the sale was attributable to a U.S. office (or other fixed place of business) and sold through the U.S. office. The Act repealed this rule but generally made income derived from the sale of any personal property (including inventory property) by a nonresident (as defined in section 865 for personal property source rule purposes) U.S. source when the sale is attributable to a U.S. office (or other fixed place of business). Because the Act also generally retains the place-of-sale rule for sales of inventory property by residents (as defined in section 865), the repeal of the effectively connected rule would allow these residents who are treated for general purposes (outside section 865) as nonresident aliens to avoid U.S. tax on income attributable to a U.S. office by placing sales of inventory property outside the United States.

The Act's legislative history indicated that Congress intended that the Act's source rule changes prevail over treaty source rules for foreign tax credit limitation purposes to the extent necessary to insure that income not taxed by a foreign country not escape U.S. tax as well. This policy was to apply to all the source rule changes in the Act, not just those applicable to personal property. Although the Act and its legislative history did not specifically address cases where some foreign tax may be paid on income treated as U.S. source under the Act, application of the later-in-time principle would result in the Act's rules prevailing over any conflicting preexisting treaty provisions.

Explanation of Provision

Definition of resident

The bill modifies the definition of resident for source rule purposes in the case of individuals and partnerships. First, the bill treats any U.S. citizen or resident alien as a U.S. resident if he or she does not have a tax home in a foreign country and, as under present law, it treats any nonresident alien as a U.S. resident if he or she has a tax home in the United States. A U.S. citizen or resident alien who has a tax home in a foreign country is treated as a nonresident for source rule purposes as is a nonresident alien who does not have a tax home in the United States.

Second, whereas the Act generally determined the source of income derived from sales of personal property by treating a partnership as a U.S. resident or nonresident based on its situs, the bill makes these determinations at the partner level, except as provided in regulations. In determining source, it is intended that, consistent with the attribution of a U.S. trade or business under section 875, a U.S. office or other fixed place of business of the partnership will be attributed to its partners.

The bill provides regulatory authority to determine source at the partnership level, for example, in cases where it is not administratively possible to apply the rules at the partner level. For example, it may be appropriate to determine source at the partnership level in the case of a publicly traded partnership which has hundreds of partners.

The bill modifies the 10-percent tax payment requirement (applicable to U.S. citizens and resident aliens maintaining tax homes in a foreign country) for bona fide residents of Puerto Rico. The 10-percent tax payment requirement is waived for an individual who is a bona fide resident of Puerto Rico for the entire taxable year on the sale of stock of a corporation which (directly or indirectly) (1) is engaged in an active trade or business in Puerto Rico, and (2) derives from the active conduct of a trade or business in Puerto Rico more than 50 percent of its gross income for the 3 years preceding the year of sale. Under this rule, bona fide residents of Puerto Rico who sell stock in certain corporations doing business in Puerto Rico generate Puerto Rican source income and, thus, retain the benefits of section 933.

The bill provides the Internal Revenue Service with authority to waive the 10-percent tax payment requirement by regulation for purposes of determining the source of income from any other sales of personal property by bona fide residents of Puerto Rico and for purposes of determining the source of income from sales of personal property by bona fide residents of Guam, American Samoa, and the Northern Mariana Islands, thus preserving benefits otherwise available under sections 931 and 933. Under this authority, for example, the Service may provide that in appropriate circumstances, gross income of a U.S. citizen who is a bona fide resident of Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands does not include the individual's otherwise untaxed (or low-taxed) income from sales of personal property in the possession. However, it is intended that regulations promulgated under this authority provide the exception only in the case where the possession has "delinked" from the mirror Code. Moreover, it is intended that regulations limit the exception to bona fide residents of one of these possessions and not to U.S. citizens or residents who may be only temporarily resident in the possession. For this purpose, it is anticipated that rules analogous to the special tax rules for nonresident aliens who are U.S. tax-avoidance expatriates (sec. 877), to the extent those provisions do not already apply because of section 1277(e) of the 1986 Act (which extends sec. 877 to certain U.S. citizens who move to certain territories), be applied.

Exceptions to residence rule

Income derived from the sale of intangibles

The bill clarifies that income to the extent of previously allowed amortization deductions derived from the sale of amortizable intangible property is sourced under the Act's recapture rule. The recapture rule applies whether or not the payments in consideration for the sale are contingent on the productivity, use, or disposition of the property. For sales where the payments are so contingent, it is intended that the source of all payments will be determined under the recapture rule until the entire recapture amount has been recaptured, and that any remaining payments will be sourced under the general intangible rules.

The bill also clarifies that gain derived from the sale of intangible property in excess of amortization recapture is sourced under the residence-of-the-seller rule when the payments in consideration for the sale are not contingent on the productivity, use, or disposition of the property. When payments are so contingent, the source rule for royalties applies to the gain.

Income attributable to an office or other fixed place of business

The bill clarifies that the office rule as it applies to U.S. persons also applies to a sale of intangible property when the payments in consideration for the sale are not contingent on the productivity, use, or disposition of the property. Thus, a U.S. resident who sells intangible property for noncontingent payments generates foreign source income as long as the sale is attributable to a foreign office and an effective rate of foreign income tax of at least 10 percent is paid on the income derived from the sale.

The bill provides the Internal Revenue Service regulatory authority to waive the office rule's 10-percent tax payment requirement for purposes of determining whether a domestic corporation has sufficient possession-source income to be eligible for the possessions tax credit (sec. 936).

The bill also modifies the office rule to conform with the Act's source rules governing space and ocean activities. This modification provides that the office rule applies to U.S. persons only if they maintain an office in a foreign country, rather than outside the United States. The bill makes similar conforming amendments to the Act's other source rule provisions.

Income derived from the sale of stock in foreign affiliates

The bill clarifies that income derived from the sale of stock of a foreign affiliate which wholly owns another foreign corporation is treated as foreign source income in certain cases. Upon an election by the U.S. resident, as long as either the parent or the subsidiary is engaged in an active trade or business in the country in which the sale occurs and 50 percent of the gross income of the holding company and the subsidiary combined for a three-year period is derived from the active conduct of a trade or business in that foreign country, then gain on the sale of stock in the holding company will be treated as foreign source.

Other rules

The bill reinstates the provision repealed by the Act that treats foreign source income derived from certain sales of inventory property by a foreign person as effectively connected with the conduct of a U.S. trade or business. This provision is necessary to ensure that foreign persons who have a substantial presence in the United States, who may be treated as U.S. residents for source rule purposes but as nonresidents for general purposes, are taxed on income derived from sales of inventory property.

The bill codifies and expands upon the Act's legislative history by providing (in connection with the changes to sec. 7852(d)) that the Act's source rule changes generally prevail over any conflicting treaty source rules under the general later-in-time rule. The bill does provide, however, an exception to the general later-in-time rule. Under this exception, a taxpayer may elect to apply treaty source rules to treat as foreign source any gain derived from the sale of stock in a treaty country corporation or of an intangible which would otherwise be treated as U.S. source under the Act. In this case, foreign taxes on that gain cannot offset U.S. tax on any other item of income, and foreign taxes on any other item of income cannot offset U.S. tax on that gain. For example, under the Act, gain from the sale of stock in a less-than-80-percent owned foreign corporation by a U.S. resident is U.S. source. A treaty may treat that income as foreign source. Under the bill, that income is subject to U.S. tax as foreign source income, but the U.S. resident may credit only foreign tax imposed on that income against the U.S. tax imposed on that income.

The bill also makes clerical and conforming amendments.

2. Special rules for exemption from U.S. tax on U.S. source transportation income (sec. 112(e) of the bill, sec. 1212 of the Reform Act, and secs. 862, 872, 883, and 887 of the Code)

Present Law

The Code's reciprocal exemption provisions sometimes exempt foreign persons from U.S. tax on U.S. source transportation income. Prior to the Act, the reciprocal exemption provisions exempted foreign persons from U.S. tax on earnings derived from the operation of ships (or aircraft) documented under the laws of a foreign country if that country exempted U.S. citizens and domestic corporations from its tax. The Act modified these provisions to provide the exemption from U.S. tax only to alien individuals who are residents of, and foreign corporations organized in, a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption.

A foreign corporation, in addition to having to be organized in a country that grants U.S. persons an equivalent exemption, must also satisfy a residence-based requirement to obtain U.S. tax exemption. Under the residence-based requirement, the ultimate individual owners of more than 50 percent of the value of the stock of the foreign corporation must be residents of a foreign country that grants U.S. citizens and domestic corporations an equivalent exemption. Thus, it is not enough for the foreign corporation to be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption: individuals ultimately owning most of its stock must reside in such a country as well. Ultimate individual ownership is determined by treating stock owned directly or indirectly by or for any entity (for example, a corporation, partnership, or trust) as being actually owned by the stockholder (or partner, grantor, or beneficiary, as the case may be) of that entity and by further attributing that ownership to its owners if necessary to reach individual owners.

The residence-based requirement does not apply to any foreign corporation organized in a foreign country that exempts U.S. persons from its tax if the stock of the corporation is primarily and regularly traded on an established securities market in that foreign country. This publicly traded exception also covers a foreign corporation that is wholly owned by a second corporation organized in the same country as the first foreign corporation if the stock of the second foreign corporation is primarily and regularly traded on an established securities market in that country.

The Act also enacted a gross basis tax on certain transportation income derived by foreign persons. The tax was intended to apply to income the source of which was modified by the Act. That is, the tax was intended to apply to transportation income derived by foreign persons that is treated as 50 percent U.S. source under the Act. Moreover, it was intended that the income on which the gross basis tax would be imposed would be the same income that would be eligible for the reciprocal exemption.

Explanation of Provision

The bill modifies the reciprocal exemption provisions so that they operate independently with respect to nonresident alien individuals and foreign corporations. Thus, for a foreign corporation to be exempt from U.S. tax, its country of organization need exempt only U.S. corporations from that country's tax. In addition, the bill refines the reciprocal nature of the exemptions for individuals, so that an exemption applies if the residence country of the individual grants an equivalent exemption to individual *residents* of the United States. The foreign country need not, for example, exempt transportation income of U.S. citizens who are not residents of the United States. A foreign country that exempts transportation income of U.S. citizens shall be treated as exempting U.S. residents for this purpose, however, so that individual residents of that foreign country will qualify for U.S. tax exemption.

The bill also modifies the publicly traded exception to the residence-based requirement. Under the bill, a foreign corporation qualifies for the reciprocal exemption if it is organized in a country which exempts U.S. corporations from that country's tax and the foreign corporation's stock is primarily and regularly traded on an established securities market in that country, another foreign country that grants U.S. corporations the appropriate exemption, or the United States. In addition, if stock of one foreign corporation, organized in a country which exempts U.S. corporations from that country's tax, is owned by a second, publicly traded corporation organized in either the same foreign country, a second foreign country that exempts U.S. corporations from that country's tax, or the United States, and the second corporation's stock is primarily and regularly traded on an established securities market in its country of organization, another foreign country that grants U.S. corporations the appropriate exemption, or the United States, then the bill treats the stock of the first corporation as owned by individuals who are resident in the country in which the second corporation (i.e., the shareholder) is organized.

As an example, assume four foreign corporations own all the stock of another foreign corporation, all five corporations are organized in countries which exempt U.S. corporations from their tax, and the stock of the first four corporations is primarily and regularly traded on established securities markets in their respective countries. In this case, the stock of each of the four corporations shall be treated as owned by individuals resident in the four corporations' respective countries of organization. (The same conclusion would follow if the stock of one or more of the first four corporations were primarily and regularly traded on an established U.S. securities market, or on an established securities market in any foreign country that exempts U.S. corporations from their tax.) Since more than 50 percent of the value of the stock of the fifth corporation is considered owned by residents of countries which exempt U.S. persons from their tax, the fifth corporation is eligible under the bill for the reciprocal exemption.

The bill also clarifies that the U.S. tax exemption applies to gross income derived from international operations only, and not to gross income derived from U.S. operations. That is, transportation income that would be sourced entirely in the United States under section 863(c)(1) is not eligible for the exemption. For example, if a cargo company that is organized in a foreign country that grants U.S. corporations exemption from its tax transports cargo to one U.S. port, and picks up additional cargo in that port for transport to a second U.S. port, then the income attributable to the transportation of the cargo picked up at the first U.S. port and delivered to the second U.S. port is not eligible for U.S. tax exemption. The income attributable to the transportation of the cargo from the foreign country to the second U.S. port is eligible for U.S. tax exemption. (As indicated in Part XII.H.1 below, if a U.S. income tax treaty provides different jurisdictional provisions that conflict with the statutory provisions described above, the treaty will generally prevail.)

The bill further clarifies that the transportation income on which the gross basis tax is imposed is that income that is treated as 50 percent U.S. source by the Act. In addition, the bill provides that under regulations transportation income on which the tax is imposed may be reduced to correspond to income that is eligible for the reciprocal exemption.

3. Source rule for space and certain ocean activities (sec. 112(f) of the bill, sec. 1213 of the Reform Act, and sec. 863 of the Code)

Present Law

The Act enacted source rules for activities conducted in space, on or beneath the ocean, and on Antarctica. In defining the term "space or ocean activity", the Act excluded an activity giving rise to international communications income. The Act defined international communications income to include all income derived from the transmission of communications or data from the United States to any foreign country or from any foreign country to the United States. The Act did not define foreign country for this purpose.

Explanation of Provision

The bill modifies the definition of international communications income to include all income derived from the transmission of communications or data from the United States to any possession of the United States (and vice-versa) as well as to any foreign country.

4. Limitations on special treatment of 80/20 corporations (sec. 112(g) of the bill, sec. 1214 of the Reform Act, and secs. 861, 864, 907, 1442, and 2105 of the Code)

Present Law

Prior to the Act, a U.S. corporation's dividend and interest payments were foreign source and not subject to U.S. withholding tax when at least 80 percent of the U.S. corporation's income over the prior three years was from foreign sources (this type of corporation was commonly referred to as an 80/20 company). The Act repealed prior law as it applied to dividends paid by an 80/20 company (other than dividends paid by a possessions corporation) and treats dividends paid by U.S. corporations as U.S. source. Dividends received by foreign persons from U.S. corporations, though treated as U.S. source, receive look-through treatment for U.S. withholding tax purposes when the corporation satisfies an active foreign business requirement. In such a case, the amount of the withholding tax exemption is based on the source of the income earned by the U.S. corporation. With respect to interest payments by a U.S. corporation, the Act generally treats the interest as U.S. source unless the corporation satisfies the active foreign business requirement. If the active foreign business requirement is met, the Act treats interest paid by a U.S. corporation as foreign source if the interest is paid to an unrelated party and as having a prorated source based on the source of the payor's income if the interest is paid to a related party.

The active foreign business requirement is satisfied if at least 80 percent of the U.S. corporation's gross income for the 3-year period preceding the year of the payment is derived from foreign sources and is attributable to the active conduct of a trade or business in one or more foreign jurisdictions (or U.S. possessions).

The 80-percent active foreign business requirement may be met by the U.S. corporation alone or, instead, may be met by a group including domestic or foreign subsidiaries in which the U.S. corporation owns a controlling interest. It is intended that at least a 50-percent ownership interest be required for a subsidiary's business to be attributed to a U.S. shareholder. In allowing attribution of a subsidiary's active foreign business to a controlling corporate shareholder, the character (i.e., active foreign business income) of the subsidiary's gross income is intended to be attributed to the corporate shareholder only on the actual inclusion of income from the subsidiary, for example, dividends, interest, rents, or royalties, and for the purpose of determining the percentage of dividends paid by the shareholder that are subject to U.S. withholding tax. Thus, for example, dividends received by a corporate shareholder from controlled U.S. subsidiaries, though treated as U.S. source in the hands of the corporate shareholder, are to be characterized as active foreign business income for the purpose of this look-through rule in the same proportion that the controlled subsidiaries' active foreign business income bears to their total income. With respect to other items of income received from controlled subsidiaries, those amounts are to be characterized as active foreign business income to the extent they are allocated against active foreign business income of the payor.

Prior to the Act, certain income paid by U.S. persons to foreign persons was effectively exempted from U.S. withholding tax because the income was treated as foreign source income. Under the Act, the income is treated as U.S. source, but the exemption from U.S. withholding tax is made explicit. The interest affected includes interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution as long as such interest is a deductible expense to the savings institution under section 591, and interest on amounts held by an insurance company under an agreement to pay interest thereon, but, in each case, only if such interest is not effectively connected with the conduct of a trade or business within the United States by the recipient of the interest.

The Act also made an explicit exemption from U.S. withholding tax for income derived by a foreign central bank of issue from bankers' acceptances. By treating the interest on deposits as U.S. source, it is not intended that the principal amounts which generate the income be includible in a foreign person's estate.

Explanation of Provision

The bill clarifies that, for purposes of attributing a lower-tier corporation's active foreign business income to an upper-tier U.S. corporation, the upper-tier corporation must own directly or indirectly at least 50 percent of both the voting power and value of the stock of the lower-tier corporation.

The bill also clarifies that, for purposes of attributing a lower-tier corporation's active foreign business income to an upper-tier U.S. corporation, the source of the lower-tier corporation's income, as well as its character, is attributed to the upper-tier corporation. Thus, for example, if an upper-tier U.S. corporation receives a dividend from a qualifying lower-tier U.S. corporation, the dividend shall, for purposes of determining whether any withholding tax will be imposed on the upper-tier corporation's dividend distributions, be considered as having both the character and the source of the lower-tier corporation's income. For foreign tax credit purposes, the dividend from the lower-tier corporation is U.S. source, however.

The bill clarifies that the change in source for certain interest on deposits does not change its treatment for estate tax purposes. Thus, for example, bank deposits the interest on which is not effectively connected with a U.S. trade or business, though such interest is treated as U.S. source income, are not treated as property within the United States.

Further, the bill clarifies that the Act's provisions are generally effective for payments made in taxable years of the payor beginning after December 31, 1986.

The bill also makes clerical and conforming amendments.

5. Rules for allocation of interest, etc., to foreign source income (sec. 112(h) of the bill, sec. 1215 of the Reform Act, and sec. 864(e) of the Code)

Present Law

Basis of stock of nonaffiliated 10-percent owned corporations

When the tax book value method of expense apportionment is used, the Act provides a new rule to allocate and apportion expenses on the basis of assets when the asset is stock in one of certain corporations. If a 10-percent or more owned corporation is not included in the group treated as one taxpayer, then, in general, the adjusted basis of the stock owned in such corporation in the hands of a U.S. shareholder is increased by the amount of the earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held it. Earnings and profits are not limited to those accumulated in post-enactment years. (In general, two kinds of 10-percent owned corporations are not included in the one-taxpayer group: foreign corporations, and U.S.

corporations that are more than 10- but less than 80-percent owned.) In the case of a deficit in earnings and profits of the corporation that arose during the period when the U.S. shareholder held the stock, that deficit reduces the adjusted basis of the asset in the hands of the shareholder. In that case, however, the deficit cannot reduce the adjusted basis of the asset below zero.

Under prior law and under the Act, subpart F inclusions increase stock basis in but do not decrease earnings and profits of a controlled foreign corporation (secs. 961 and 959). Congress did not intend that the addition of such amounts to stock basis by virtue of a subpart F inclusion (or another inclusion with an equivalent effect on basis) result in double counting.

Allocation of expenses to deductible dividends

The Act provides that for purposes of allocating or apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account. A similar rule applies in the case of any dividend from a U.S. corporation that is eligible under section 243 for the 80-percent dividends received deduction (but not in the case of a dividend from a U.S. corporation that is eligible for the 100-percent dividends received deduction) and in the case of any dividend from a foreign corporation a fraction of which (that reflects its U.S. earnings) is eligible under section 245(a) for an 80-percent dividends received deduction.

Treatment of bank holding companies and banks

While the Act generally requires an affiliated group to be treated as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense, that general rule does not apply to any financial institution (described in section 581 or 591) if the business of the financial institution is predominantly with persons other than related persons or their customers, and if the financial institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution. A bank to which this exception applies is not treated as a member of the group for applying the Act's general one-taxpayer rule for interest expense allocation and apportionment to other members of the group; instead, that bank and all other banks in the group are to be treated as one taxpayer (rather than each bank being treated as a separate taxpayer for this purpose).

Although treated separately from other group members for interest expense allocation, banks were intended to be treated as part of the overall group that the Act treats as one taxpayer for expenses other than interest.

Direct allocation of interest expense when deduction is denied

The Act provides that the Secretary is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing for direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest (or interest-type income) derived from such transaction.

In certain cases, the dividends received deduction is reduced in cases where portfolio stock is debt financed (sec. 246A). In addition, a life insurance company is allowed a dividends received deduction for its share of dividends received, but this deduction is not allowed for the policyholders' share of dividends received. Further, the reserve deduction and other deductible payments to policyholders of a life insurance company are reduced by the policyholders' share of tax exempt interest. Moreover, in the case of a property and casualty insurance company, 15 percent of the sum of tax exempt interest and the deductible portion of dividends received reduces the deduction for losses incurred (sec. 832(b)(4)).

Scope of expense allocation rules

For purposes of subchapter N of chapter 1 of the Code (secs. 861-999), except as provided in regulations, the Act provides a series of rules governing expense allocation and apportionment. The intent of the grant of regulatory authority was to allow regulations to identify provisions of this subchapter to which the new rules would not apply. The Act's rules literally apply for the determination of taxable income from sources outside the United States. With one exception, however, these rules were intended to apply for all determinations under subchapter N of chapter 1, whatever the source (U.S. or foreign) of the income against which expenses are allocated. The exception relates to the possessions tax credit: Congress did not intend that new section 864(e)(1) apply for purposes of computations under section 936(h).

Transition rules

The Act provides a number of transition rules designed to phase in the application of the new expense allocation rules insofar as they relate to interest expenses.

Explanation of Provisions

Basis of stock of nonaffiliated 10-percent owned corporations

The bill clarifies the Act's rule governing the allocation and apportionment of expenses when the tax book value method is used and the asset at issue is stock in one of certain corporations. The adjusted basis of any stock in a nonaffiliated 10-percent owned corporation is increased by the amount of earnings and profits of that corporation attributable to that stock and accumulated during the period the taxpayer held the stock, or reduced, but not below zero, by any deficits in earnings and profits in that corporation attributable to that stock for that period. For this purpose, a "nonaffiliated 10-percent owned corporation" is one that is not included in the taxpayer's affiliated group, and in which members of the affiliated group own 10 percent or more of the voting power. The bill makes it clear that the adjustment to asset value on a look-through basis is also applied to stock of foreign corporations that is not directly held by U.S. taxpayers but that is indirectly 10-percent owned by U.S. taxpayers. Stock owned directly or indirectly by a corporation, partnership, or trust is treated as being owned proportionately by its shareholders, partners or beneficiaries. When a taxpayer is treated under this look-through rule as owning stock in a lower-tier corporation, the adjustment to the basis of the upper-tier corporation in which the taxpayer actually owns stock is to include an adjustment for the amount of the earnings and profits (or deficit in earnings and profits) of the lower-tier corporation which were attributable to the stock the taxpayer is treated as owning and to the period during which the taxpayer is treated as owning that stock.

The bill provides that, for purposes of section 864(e), proper adjustment is to be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under the subpart F current inclusion rules (or under any other provision) that are reflected in the adjusted basis of the stock. Thus, a subpart F inclusion, which increases stock basis but does not decrease earnings and profits of a controlled foreign corporation, is not to result in double counting.

Allocation of expenses to deductible dividends

The bill makes it clear that to the extent any dividend benefits from the dividends received deduction under section 243 (allowing an 80-percent dividends received deduction for certain dividends from U.S. corporations) or section 245(a) (allowing an 80-percent dividends received deduction for the U.S. source portion of certain dividends from foreign corporations), that portion of the dividend is treated as tax exempt income for the purpose of the Act's expense allocation rules and that portion of the related asset is treated as a tax exempt asset.

Treatment of bank holding companies and banks

The bill provides that, to the extent provided in regulations, a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), and any subsidiary of a bank holding company (or of a financial institution described in section 581 or 591) that is predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business, shall be treated as a financial institution for purposes of the exception that applies in certain cases to financial institutions described in section 581 or 591. The bill also makes it clear that any financial institution that is excluded from the general one-taxpayer group and is included in a one-taxpayer group covering financial institutions is not so treated for purposes of expenses other than interest. That is, financial institutions and all other affiliated entities are treated as one taxpayer under the Act for expenses other than interest.

Direct allocation of interest expense when deduction is denied

The bill provides that the Secretary is to prescribe regulations for direct allocation of interest expense in the case of indebtedness resulting in a disallowance under section 246A, which reduces the dividends received deduction in cases where portfolio stock is debt financed. Thus, to the extent that an interest deduction reduces the amount of the dividends received deduction, the interest expense generating the loss of the dividends received deduction is to be treated as directly allocable to the income resulting from the loss of the dividends received deduction.

The bill also provides that the Secretary is to prescribe regulations that make appropriate adjustments in the application of the rule that disregards tax-exempt assets and income derived therefrom in the case of an insurance company.

Scope of expense allocation rules

The bill provides that new section 864(e) (relating to expense allocation) shall not apply for purposes of any provision of subchapter N of chapter 1 of the Code (secs. 861-999) to the extent the Secretary determines under regulations that the application of this subsection for such purposes would not be appropriate. In a conforming amendment, the bill deletes the provision for exceptions to new section 864(e) in the introductory language to that subsection.

With one exception, the bill makes it clear that these rules apply for all determinations under subchapter N of chapter 1, whatever the source of the income against which expenses are allocated. The exception relates to the possessions tax credit: section 936(h) is to apply as if new section 864(e)(1) had not been enacted.

Transition rules

The bill clarifies the operation of the Act's transition rules.

One set of the bill's provisions clarifies the Act's phase-in of the new rules governing interest expense allocation generally. (This set of the bill's provisions does not affect the Act's phase-in of the one-taxpayer rule of new Code sec. 864(e)(1), which is described below.) These clarifications, the bill's "general" phase-in provisions, apply to the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985. In the case of the first three taxable years of the taxpayer beginning after December 31, 1986, the Act's amendments relating to interest expense allocation (other than the one-taxpayer rule of new sec. 864(e)(1)) do not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount. Except for certain reductions in indebtedness, the consequences of which are described below, the general phase-in amount is the applicable percentage of the taxpayer's debt outstanding on November 16, 1985. In the case of the first taxable year, the applicable percentage is 75; in the case of the second taxable year, the applicable percentage is 50; in the case of the third taxable year, the applicable percentage is 25.

The general phase-in amount eligible for relief for any period, however, is not to exceed the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985. This limitation is designed to implement the Act's intent to target transitional relief to corporate groups that had borrowed in reliance on prior law and to deny transitional relief to the extent that the level of debt increases. To the extent provided in regulations, the average amount of indebtedness outstanding during any month is to be used in lieu of the amount outstanding as of the close of such month for this purpose. This grant of regulatory authority is designed to allow the Internal Revenue Service to disallow transition relief to taxpayers whose month-end debt levels are not representative of their monthly debt levels generally. Reductions in debt as of a month's end are not to reduce phase-in relief for prior months, however. For example, if a calendar year taxpayer's outstanding debt is $100 on November 16, 1985 and at all times thereafter until December 1, 1987, at which time it pays off all its debt, the taxpayer is entitled to general phase-in treatment for interest on $75 during the first 11 months of 1987.

In addition, the bill's "special" phase-in rules clarify the Act's provisions that phase in the one-taxpayer rule (new sec. 864(e)(1)). In the case of the taxpayer's first 5 taxable years beginning after December 31, 1986, the Code's new one-taxpayer rule (sec. 864(e)(1)) is not to apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness that does not exceed the special phase-in amount. The special phase-in amount is generally the sum of three separate amounts: the general phase-in amount, described above, the 5-year phase-in amount, and the 4-year phase-in amount. The special phase-in amount, however, like the general phase-in amount, cannot exceed the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985.

The 5-year phase-in amount is the lesser of two amounts. The first amount is an applicable percentage of the "5-year base." The 5-year base is the excess (if any) of the amount of a taxpayer's outstanding indebtedness on May 29, 1985, over the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. For this purpose, however, the 5-year base cannot exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985. The applicable percentage, in each year, is the excess of the percentage granted relief under the Act's 5-year phase-in over the percentage granted relief under the Act's general (3-year) phase-in. In the case of the first taxable year beginning after December 31, 1986, the applicable percentage is 8-1/3 (83-1/3 - 75); in the case of the second taxable year, the applicable percentage is 16-2/3 (66-2/3 - 50); in the case of the third taxable year, the applicable percentage is 25 (50 - 25); in the case of the fourth taxable year, the applicable percentage is 33-1/3; and in the case of the fifth taxable year, the applicable percentage is 16-2/3.

The 5-year phase-in amount cannot exceed a second amount. That second amount, which is in the nature of a limitation, caps the 5-year phase-in amount in cases where reductions of indebtedness ("paydowns") reduce the taxpayer's debt below the amount that would have been eligible for 5-year relief had no paydown occurred. More specifically, the second amount is the 5-year base, reduced (but not below zero) by paydowns of debt, and then multiplied by a percentage. The paydowns that reduce the 5-year base for this purpose are defined as the excess of the taxpayer's November 16, 1985, debt over the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985 (or to the extent provided in regulations, as under the general phase-in, the average amount of indebtedness outstanding during any such month).

To compute this second amount, the (possibly reduced) 5-year base is multiplied by a fraction the numerator of which is the applicable 5-year percentage (the excess of the 5-year percentage under present law over the 3-year percentage), and the denominator of which is the sum of the applicable percentage under the general (3-year) rule and the applicable percentage under the 5-year rule. This second amount limits the 5-year base only in cases where paydowns reduce the amount of the 5-year base below the amount of relief that would be granted if no paydown had occurred. In the case of the first taxable year beginning after December 31, 1986, this percentage is 10, *i.e.*, 8-1/3 divided by the sum of 8-1/3 and 75; in the case of the second taxable year, this percentage is 25, *i.e.*, 16-2/3 divided by the sum of 50 and 16-2/3; in the case of the third taxable year, this percentage is 50, *i.e.*, 25 divided by 50; in the case of the fourth taxable year, this percentage is 100, *i.e.*, 33-1/3 divided by 33-1/3; and in the case of the fifth taxable year, this percentage is 100, *i.e.*, 16-2/3 divided by 16-2/3.

This second amount preserves the full 5-year benefit in cases where the taxpayer's lowest debt is equal to or greater than the product of the 5-year base (unreduced by paydowns) and Act's 5-year percentage. (The Act's 5-year percentage is restructured under the bill as the sum of two applicable percentages: the applicable percentage for the purpose of the general (3-year) rule and the add-on applicable percentage for the purpose of the 5-year rule.) If paydowns have reduced outstanding debt below the amounts that would have obtained full benefit under the 5-year rule had no paydowns occurred, this second amount reduces the 5-year benefit on a linear basis.

The 4-year phase-in amount is the lesser of two amounts. These amounts parallel the principles set forth above in connection with the 5-year amounts. The first amount is the applicable percentage of the "4-year base." The 4-year base is the excess (if any) of the amount taxpayer's outstanding indebtedness on December 31, 1983, over the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1982. For this purpose, however, the 4-year base cannot exceed the excess of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985 over the 5-year base. The applicable percentage, in each year, is the excess of the percentage granted relief under the Act's 4-year phase-in over the percentage granted relief under the Act's general (3-year) phase-in. In the case of the first taxable year beginning after December 31, 1986, the applicable percentage is 5 (80 - 75); in the case of the second taxable year, the applicable percentage is 10 (60 - 50); in the case of the third taxable year, the applicable percentage is 15 (40 - 25); and in the case of the fourth taxable year, the applicable percentage is 20.

The 4-year phase-in amount cannot exceed a second amount. That second amount is intended to reduce the 4-year phase-in amount to the extent that paydowns reduce the taxpayer's debt below the amount that would be eligible for 4-year relief had no paydown occurred. More specifically, the second amount is the 4-year base, reduced (but not below zero) by certain paydowns of debt, multiplied by a percentage. The paydowns that reduce the 4-year base for this purpose are generally defined as the excess of the taxpayer's November 16, 1985, debt, over the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985 (or to the extent provided in regulations, as under the general phase-in, the average amount of indebtedness outstanding during any such month). This paydown amount for 4-year purposes is reduced, but not below zero, by the amount of the 5-year base.

For purposes of this second amount, the (possibly reduced) 4-year base is multiplied by a fraction the numerator of which is the percentage added to general relief under the 4-year rule and the denominator of which is the percentage granted relief after the application of both the 4-year rule and the general (3-year) relief. In the case of the first taxable year beginning after December 31, 1986, this percentage is 6.25, *i.e.*, 5 divided by (5 + 75); in the case of the second taxable year, this percentage is 16-2/3, *i.e.*, 10 divided by 60; in the case of the third taxable year, this percentage is 37.50, *i.e.*, 15 divided by 40; and in the case of the fourth taxable year, this percentage is 100, *i.e.*, 20 divided by 20.

The bill provides that, to the extent possible, the general and special phase-in rules are to apply to the same amount of indebtedness.

The bill clarifies that amounts eligible for relief under the Act's phase-in rules are determined on the basis of indebtedness rather than interest expense. The bill is not intended to require that specific interest expense be traced to specific indebtedness.

The following examples involve the application of the special phase-in rule for one-taxpayer treatment and the general phase-in rule for the Act's other interest expense allocation rules.

Example 1

A U.S. parent company, a calendar year taxpayer, had outstanding third party interest-bearing debt of $50 from 1980 until December 31, 1982. On July 1, 1983, the taxpayer's third party interest-bearing debt increased to $70. On July 1, 1984, the taxpayer's third party interest-bearing debt increased to $100. All this debt bore and bears annual interest at the same interest rate.

The U.S. parent corporation's third party debt is $100 on November 16, 1985, and at all relevant times thereafter.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of sec. 864(e)(1)) to interest on 75 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of section 864(e)(1), operates as follows. The special phase-in amount, that is, the amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $75) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "5-year base." The 5-year base is $30, the excess of $100, the amount of the taxpayer's outstanding indebtedness on May 29, 1985, over $70, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 8-1/3. Thus, the first amount is $2.50, that is, 8-1/3 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $30, unaffected here by paydowns of debt since none have occurred, and then multiplied by 10 percent, *i.e.*, 8-1/3 divided by the sum of 8-1/3 and 75. Thus, the second amount is $3 ($30 multiplied by 10 percent).

In this case, the 5-year amount is thus $2.50, the lesser of $2.50 and $3.

The 4-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "4-year base." The 4-year base is $20, the excess of $70, the amount of the taxpayer's outstanding indebtedness on December 31, 1983, over $50, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1982. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 5. Thus, the first amount is $1, that is, 5 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, unaffected here by paydowns of debt since none have occurred, and then multiplied by 6.25 percent, *i.e.*, 5 divided by the sum of 5 and 75. Thus, the second amount is $1.25 ($20 multiplied by 6.25 percent).

In this case, the 4-year amount is thus $1, the lesser of $1 and $1.25.

Thus, in this example, the amount of debt qualifying for relief from one-taxpayer treatment is $78.50, which is the sum of $75, the general phase-in amount; $2.50, the 5-year phase-in amount; and $1, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $3.50 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $21.50 is to be apportioned under the Act's new rules.

Example 2

Assume the same facts as in the example above, except that the U.S. parent corporation's third party debt is $100 on November 16, 1985, and until January 1, 1987, at which time it pays its debt down to $85. Its debt remains $85 at all relevant times thereafter.

Again, the general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of sec. 864(e)(1)) to interest on $75. That is, the new rules (other than the one-taxpayer rule of sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's lowest debt level, $85, has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of section 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (again determined above to be $75) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is again $2.50, that is, 8-1/3 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $30, reduced by the $15 paydown of debt (representing the difference between the November 16, 1985, amount and the $85 lowest monthly amount) to $15 and then multiplied by 10 percent. Thus, the second amount is $1.50 ($15 multiplied by 10 percent).

In this case, the 5-year amount is thus $1.50, the lesser of $2.50 and $1.50.

The 4-year phase-in amount is again the lesser of two amounts. The first amount again is $1, that is, 5 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, subject to reduction on account of the paydown of debt, multiplied by 6.25 percent. There is no reduction on account of paydowns in this example, because the $15 paydown for 4-year purposes is reduced, but not below zero, by the $30 amount of the 5-year base. Thus, the second amount is again $1.25 ($20 multiplied by 6.25 percent).

In this case, the 4-year amount is thus $1, the lesser of $1 and $1.25.

Thus, in this example, the amount of debt qualifying for relief from one-taxpayer treatment is $77.50, which is the sum of $75, the general phase-in amount; $1.50, the 5-year phase-in amount; and $1, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $2.50 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $22.50 is to be apportioned under the Act's new rules.

Example 3

A third example examines the third taxable year beginning after 1986, the calendar year 1989. In this example, the facts are the same as in the first two examples, except that the taxpayer paid its debt down to $80 on January 1, 1989. Its debt remains at $80 throughout 1989.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of sec. 864(e)(1)) to 25 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of sec. 864(e)(1), discussed below) cannot apply to interest on $25 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below $25.

The special phase-in rule, which governs the application of the one-taxpayer rule of section 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $25) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage (25) of the 5-year base ($30). Thus, the first amount is $7.50, that is, 25 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the third taxable year beginning after December 31, 1986, that second amount is $5 (the 5-year base, $30, reduced by the $20 paydown) multiplied by 50 percent. Thus, the second amount is $5 ($10 multiplied by 50 percent).

In this case, the 5-year amount is thus $5, the lesser of $7.50 and $5.

The 4-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage for the third taxable year beginning after 1986 of the 4-year base ($20). The applicable percentage, in the third taxable year beginning after December 31, 1986, is 15. Thus, the first amount is $3, that is, 15 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the third taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, subject to reduction on account of the paydown of debt, multiplied by 37.5 percent. There is no reduction on account of paydowns in this example, because the $20 paydown for 4-year purposes is reduced, but not below zero, by the $30 amount of the 5-year base. Thus, the second amount is $7.50 ($20 multiplied by 37.5 percent).

In this case, the 4-year amount is thus $3, the lesser of $3 and $7.50.

Thus, in this example, the amount of debt qualifying for relief from one-taxpayer treatment is $33, which is the sum of $25, the general phase-in amount; $5, the 5-year phase-in amount; and $3, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $25 of debt is to be allocated under old law, interest expense on $8 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $67 is to be apportioned under the Act's new rules.

Example 4

A U.S. parent company, a calendar year taxpayer, had no outstanding third party interest-bearing debt until July 1, 1984, on which date the taxpayer's third party interest-bearing debt became $100. All this debt bore and bears annual interest at the same interest rate.

The U.S. parent corporation's third party debt is $100 on November 16, 1985, and at all relevant times thereafter until January 1, 1986, when it drops to $80. On January 1, 1987, the U.S. parent corporation's third party debt increases to $85.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of sec. 864(e)(1)) to interest on 75 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of section 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $75) and the 5-year amount, but subject on these facts to a cap. (The 4-year amount is zero.)

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "5-year base." The 5-year base is $100, the excess of $100, the amount of the taxpayer's outstanding indebtedness on May 29, 1985, over $0, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 8-1/3. Thus, the first amount is $8.33, that is, 8-1/3 percent of $100.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $100, reduced by the $20 paydown to $80, and then multiplied by 10 percent. Thus, the second amount is $8 ($80 multiplied by 10 percent).

In this case, the 5-year amount is thus $8, the lesser of $8.33 and $8.

Before application of the cap to the special phase-in amount, the special phase-in amount is $83, that is, the sum of $75 and $8. The special phase-in amount, however, cannot exceed $80, the lowest amount of debt outstanding as of the close of any preceding month beginning after November 16, 1985. Therefore, the amount of debt qualifying for relief from one-taxpayer treatment is $80. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $5 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $5 is to be apportioned under the Act's new rules.

The bill clarifies that for transition rule purposes, all members of an affiliated group of corporations are to be treated as one corporation. Thus, the bill makes it clear that debt of all members is to be aggregated in determining if a paydown that reduces phase-in benefits has occurred. Similarly, the bill makes it clear that interest on interaffiliate debt is not eligible for transition relief.

Finally, in view of the relative complexity of these transition rules, the bill allows taxpayers to elect out of their application in prescribed circumstances.

C. U.S. Taxation of Income Earned Through Foreign Corporations (sec. 112(i)-(l) of the bill, secs. 1023, 1221, and 1224-1226 of the Reform Act, and secs. 245, 246A, 552, 861, 881, 901, and 951-955 of the Code)

1. Captive insurance companies

Present Law

Election to treat related person insurance income as effectively connected with a U.S. business

Under subpart F of the Code, certain types of income of U.S.-controlled foreign corporations are included currently in shareholder income and taxed by the United States regardless of whether the income is actually distributed currently to shareholders. A taxpayer is generally subject to income inclusion under subpart F only if the taxpayer is a "U.S. shareholder" in a "controlled foreign corporation." Since the enactment of the subpart F rules in 1962, the term "U.S. shareholder" has generally been limited to those U.S. persons owning (directly, indirectly, or by attribution) 10 percent or more of a foreign corporation's combined voting power. The term "controlled foreign corporation" has generally been limited to those foreign corporations more than half of the stock of which is owned by U.S. shareholders (under the Act, more than half by vote or by value).

The Act introduced new subpart F rules for taxing the income of so-called captive foreign insurance companies. Under the new rules, related person insurance income of these companies is currently taxable to an expanded category of U.S. persons. The statute achieves this result first by treating as a "U.S. shareholder" any U.S. person who owns directly or indirectly *any* stock in a foreign corporation, whether or not the amount of stock owned meets the 10 percent threshold; and second by lowering the U.S. shareholder ownership threshold for controlled foreign corporation status to 25 percent or more. These modifications apply only for purposes of taking into account related person insurance income under subpart F.

The Act provides three exceptions to the new subpart F rules for captive insurers. Under one of these exceptions, a foreign corporation may avoid the application of the new subpart F rules for captives by electing to treat related person insurance income that would not otherwise be taxed on a net basis (i.e., as effectively connected with the conduct of a U.S. trade or business) as income that *is* effectively connected with the conduct of a U.S. trade or business. The income deemed to be effectively connected under this election will be excluded from subpart F income.

Congress intended the election to be available only in two cases: (a) where the corporation is a controlled foreign corporation solely by virtue of the new rules for captive insurers and (b) where the corporation is a controlled foreign corporation regardless of the new captive rules but does not have a 10-percent U.S. shareholder that owns directly or indirectly (other than by attribution under section 958(b)) stock in the controlled foreign corporation. The Act provides that the election is to be made at such time and in such manner as the Secretary may prescribe. The election is effective in the year made and in all future years. The election is not effective if the electing corporation fails to meet such requirements as the Secretary shall prescribe to ensure that the tax imposed on its related person insurance income is paid.

To make the election, the foreign corporation must waive all U.S. income tax treaty benefits with respect to its related person insurance income. Treaty benefits with respect to the branch profits tax newly created by the Act are irrelevant to income with respect to which the election is properly made, however, because the Act excludes from the imposition of branch profits tax the earnings and profits attributable to income treated as effectively connected solely because of the election.

Amount of subpart F inclusion

When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the subpart F income. Related person insurance income (as defined by the Act) is a type of subpart F income.

In the case of a corporation that is a controlled foreign corporation for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the corporation throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed with respect to the shareholder's stock if on the last day of the taxable year the controlled foreign corporation had distributed all of its subpart F income pro rata to all of its shareholders.

The pro rata share definition provides for adjustments where the corporation is a controlled foreign corporation for less than the entire year or where actual distributions are made with respect to stock the shareholder owns for less than the entire year. The latter adjustment, contained in section 951(a)(2)(B), reduces a U.S. shareholder's pro rata share by a fraction of the dividends distributed to any other person during the controlled foreign corporation's taxable year on stock owned by the U.S. shareholder at year-end. The fraction equals the proportion of the taxable year during which the U.S. shareholder did not own the stock.

Primary insureds

The Act defines related person insurance income as any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (as defined above) in the foreign corporation receiving the income or a person related to such a shareholder.

It was Congress's intent that related person insurance income include income attributable to policies of reinsurance issued by a foreign corporation to its U.S. shareholders that previously insured the risks covered by such policies or to persons related to such shareholders that previously insured the risks covered by such policies. In addition, Congress gave the Secretary authority under the Act to prevent the avoidance of the captive insurance rules through cross insurance arrangements or otherwise.

The new subpart F rules for captive insurers do not apply if less than 20 percent of the stock of the corporation (by vote or by value of both stock and policies) is owned (directly or indirectly) by persons who are the primary insureds under any policies of insurance or reinsurance issued by the corporation, or by persons related to such primary insureds.

Gross insurance income

Under a de minimis exception to the new subpart F rules for captive insurers, these rules do not apply to income of a foreign corporation whose related person insurance income for the taxable year is less than 20 percent of its insurance income for the year. Congress intended that this computation be performed on a gross basis. Insurance income is defined for this purpose as it is generally for subpart F purposes under the Act, except that the exclusion of income attributable to same-country risks does not apply.

Definition of related person

The application of the new captive insurance rules turns on the distinction between persons who are and are not related to U.S. shareholders (within the meaning of section 954(d)(3) as amended by the Act). A person is related to a controlled foreign corporation if the person controls, is controlled by, or is under common control with the controlled foreign corporation.

Congress intended that related person insurance income include income attributable to officers' or directors' insurance where the U.S. shareholders of the foreign corporation receiving such income (or persons related to such shareholders) directly or indirectly pay the premiums and the insureds are officers or directors of the U.S. shareholders (or persons related to such shareholders).

Definition of related person insurance income

As stated above, the Act defines related person insurance income as a type of "insurance income." The Code provides special rules for computing tax haven insurance income that is subject to current taxation under subpart F. Section 953(b) states that for these purposes all items of income, expenses, losses, and deductions shall be properly allocated or apportioned under regulations prescribed by the Secretary. Section 953(b) also eliminates or limits the applicability of certain provisions of subchapter L of the Code ("Insurance Companies") for these purposes. Congress intended that these special rules for computing tax haven insurance income apply in computing related person insurance income.

Information returns

Under the Code, U.S. persons who own or acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership are required to file information returns concerning the corporation and its shareholders (sec. 6046; *see* Schedule O (Form 5471) (previously Form 959)). Regulations excuse any shareholder from furnishing required information if it is furnished by another person having an equal or greater stock interest in the corporation (Reg. sec. 1.6046-1(e)(5)). Due to its 5 percent stock ownership threshold, this reporting requirement generally applied to all U.S. shareholders in controlled foreign corporations prior to the Act. Under the new captive rules, however, a person owning less than 5 percent of the stock of a controlled foreign corporation may also be a U.S. shareholder. Generally Congress did not intend to treat such less-than-5-percent U.S. shareholders any differently from other U.S. shareholders in controlled foreign corporations for reporting purposes.

Sales of captive company stock

Generally, a U.S. shareholder in a controlled foreign corporation receives an income inclusion under subpart F when the shareholder owns stock in the corporation on the last day of the taxable year on which the corporation is a controlled foreign corporation (sec. 951(a)(1)). Prior to the Act, any U.S. shareholder that sold or exchanged stock in a controlled foreign corporation (or received a distribution which was treated as an exchange of stock in the corporation) before the last day of the year generally would have been required to treat the gain on the sale as a dividend, to the extent of the earnings and profits of the corporation attributable to such stock and accumulated since 1962 during periods in which the corporation was a controlled foreign corporation and in which the U.S. person held the stock sold or exchanged (sec. 1248). Thus a midyear stock sale would result in shareholder dividend income similar to an income inclusion under subpart F.

Under present and prior law, this rule for treating gains as dividends applies only to the class of U.S. shareholders defined under the usual 10 percent ownership threshold of subpart F—that is, the class of U.S. shareholders as that term was defined prior to the Act. The Act's captive insurance rules, however, created a new class of U.S. shareholders that need not satisfy this 10 percent threshold. Congress did not intend to treat this new class of U.S. shareholders differently from 10-percent U.S. shareholders for purposes of the existing rule for treating gains as dividends.

Uninsured, unrelated shareholders

Under the new captive insurance rules, the term U.S. shareholder includes a U.S. person that owns any stock in a foreign corporation that owns (directly or indirectly) any stock in a foreign corporation that earns related person insurance income.

Explanation of Provisions

Election to treat related person insurance income as effectively connected with a U.S. business

The bill supplements the Code provisions describing the election to treat related person insurance income as effectively connected with the conduct of a U.S. trade or business in order to clarify that the election is not available to a corporation that, without applying the special subpart F rules for captive insurance companies, is a controlled foreign corporation for an uninterrupted period of 30 days or more during the taxable year with a U.S. shareholder that owns directly or indirectly (other than by the attribution rules of 958(b)) stock in the foreign corporation, or that was such a controlled foreign corporation for such a period for any pre-election taxable year beginning after 1986. The bill further provides that if a corporation is entitled to make the election in one year, but in a later year becomes a controlled foreign corporation with such a U.S. shareholder as defined by the general subpart F rules, an election made for the earlier year shall not apply to any taxable year after the later year. Thus, the bill clarifies that the election is available only in situations where a foreign corporation and its shareholders are subject to subpart F treatment by virtue of the Act's special captive insurance rules, and not where subpart F treatment results from application of the rules that are generally applicable outside the captive insurance context.

The bill also provides that in making the election the foreign corporation must waive all benefits granted by the United States (other than benefits with respect to the branch profits and branch interest taxes newly imposed by the Act) under any treaties between the United States and any foreign country. Thus, for example, U.S. tax benefits claimed under a friendship, commerce, and navigation treaty would have to be waived by a foreign corporation making the election. However, the bill clarifies that treaty benefits with respect to the branch taxes need not be waived with respect to related person insurance income when that income is effectively connected without regard to the election.

Amount of subpart F inclusion

The bill provides a special definition of "pro rata share" for purposes only of taking into account related person insurance income. For these purposes, the special pro rata share definition is the lesser of (i) the amount which would be determined under the general subpart F definition of pro rata share if only related person insurance income were taken into account, if stock owned by U.S. shareholders on the last day of the taxable year were the only stock in the foreign corporation, and if only distributions received by U.S. shareholders were taken into account under section 951(a)(2)(B); or (ii) the amount which would be determined under the general subpart F definition of pro rata share if the entire earnings and profits of the corporation for the taxable year were subpart F income.

For example, assume that throughout the first taxable year of a foreign corporation, 50 percent of its stock is owned by U.S. persons and the rest by foreign persons unrelated to U.S. persons. The corporation's only activity is insuring risks of its U.S. shareholders and its foreign shareholders. During the taxable year exactly 50 percent of its income is related person insurance income and its earnings and profits for the year are twice its related person insurance income for the year. Assume that the corporation has no U.S. tax liability, that it has no other subpart F income for the taxable year, and that it does not distribute any of its earnings or invest in U.S. property during the year.

Under the Act's new rules for captives, all U.S. persons that own stock in the corporation are U.S. shareholders. Under the general subpart F rules for computing their income inclusions, they would be treated as if the corporation distributed to them half of its related person insurance income. This portion of the corporation's related person insurance income would be taxed to the U.S. shareholders; the rest of the corporation's related person insurance income would not be taxed currently by the United States. Under the bill, by contrast, the U.S. shareholders are taxed currently on all of the corporation's related person insurance income.

The effect of the bill's pro rata share definition is to ensure that if related person insurance income of a controlled foreign corporation is at all currently taxable to U.S. shareholders under subpart F, then the full amount of the controlled foreign corporation's related person insurance income will be currently taxable, up to the U.S. shareholders' proportionate share of the controlled foreign corporation's earnings and profits. Where the corporation earns a sufficient level of income that is not related person insurance income, partial ownership of the corporation by foreign persons will not reduce the portion of the corporation's related person insurance income that is currently taxable in the United States. As used in the bill's pro rata share definition, the term "U.S. shareholder" has the meaning that it has when taking into account related person insurance income: i.e., as modified by section 953(c)(1)(a) (which dispenses with the 10 percent threshold).

The bill further provides the Secretary with authority to modify the other rules of subpart F where necessary to permit an appropriate computation of pro rata share under the bill's special rule. For example, it may be necessary or appropriate for the Secretary to coordinate this rule with the general pro rata share definition where the controlled foreign corporation has other types of subpart F income; or regulations may be appropriate for determining how the various types of subpart F income are to be reduced to account for the earnings and profits limitation on subpart F income.

Primary insureds

The bill eliminates the word "primary" from the references to "primary insureds" in the definition of related person insurance income and in the exception from the special captive insurance rules for corporations less than 20 percent of whose owners are insureds or related to insureds. Thus the bill clarifies that these references are intended to cover policies of reinsurance issued to U.S. shareholders and related persons, regardless of whether the contracts being reinsured were issued to unrelated persons. The bill also clarifies that insurance income from contracts insuring indirectly (as well as directly) shareholders or persons related to shareholders of the foreign corporation is included in the definition of related person insurance income and that such persons indirectly (as well as directly) insured are included in the group of insured shareholders and shareholders related to insureds for purposes of determining whether the foreign corporation is less than 20 percent owned by insureds or persons related to insureds.

For example, if a foreign corporation reinsures the risk of a U.S. insurance company that insures a U.S. individual and stock of the foreign corporation is owned by the U.S. individual, then the foreign corporation's income on the reinsurance of the U.S. individual is related person insurance income under the bill because one of its U.S. shareholders is indirectly an insured of the foreign corporation. In addition, if a foreign corporation reinsures the risk of a U.S. insurance company that insures a U.S. individual and stock of the foreign corporation is owned by the U.S. insurance company, then the foreign corporation's income on the reinsurance contract is related person insurance income under the bill because one of its U.S. shareholders is directly an insured of the foreign corporation.

The foregoing amendments affecting the types of insureds whose insurance and reinsurance policies give rise to related person insurance income subject to the new captive rules generally apply to taxable years of foreign corporations beginning after 1987. However, to the extent those amendments simply eliminate the word "primary" from the references to "primary insureds," the amendments are effective as if included in the 1986 Act. That is, effective in taxable years of foreign corporations beginning after December 31, 1986, the word "primary" is dropped from sections 953(c)(2) and 953(c)(3)(A). The Secretary retains regulatory authority to identify instances where a stockholder of a foreign corporation (or a related person) is the indirect insured under a policy of insurance or reinsurance issued by the corporation, and to extend related person insurance income treatment to income from reinsurance issued to unrelated parties, in those cases where doing so is necessary to prevent the avoidance of the captive insurer rules.

Gross insurance income

The bill clarifies that for purposes of applying the de minimis exception to the captive insurance rules, comparison of a foreign corporation's related person insurance income to its insurance income is made on a gross basis. Thus, the de minimis rule is applied without regard to the relative profitability of the foreign corporation's related person insurance income, on the one hand, and its total insurance income, on the other.

Definition of related person

The bill modifies the definition of related person for purposes of the captive insurance rules, making it clear that in the case of any insurance policy covering liability arising from services performed as a director, officer, or employee of a corporation or as a partner or employee of a partnership, the person performing the services and the entity for which the services are performed will be treated as related persons. (As discussed below, the bill also raises the control threshold for related person status generally from 50 percent to more than 50 percent.)

Definition of related person insurance income

The bill refines the definition of related person insurance income so that it specifically refers to insurance income as that term is defined in section 953(a), thus incorporating the special rules set forth in section 953(b) for computing tax haven insurance income.

Information returns

The bill extends the information reporting requirements for U.S. persons who are 5 percent-or-more shareholders of foreign corporations and U.S. citizens or residents who are officers or directors of such corporations so that they apply to all persons who are U.S. shareholders in controlled foreign corporations by virtue of the new captive insurance company rules and all U.S. officers and directors of companies that are controlled foreign corporations by virtue of those rules.

Sales of captive company stock

The bill modifies the treatment of gains on sales of stock in foreign corporations that are controlled foreign corporations under the captive insurance rules to conform to the dividend treatment accorded to gains on sales of controlled foreign corporation stock in general. Thus, when a person that is a U.S. shareholder solely by virtue of the captive rules sells captive company stock to another U.S. person, for example, before the end of the taxable year, buyer and seller will each be treated as having received dividend income only with respect to that part of the year that it owned the stock.

Uninsured, unrelated shareholders

The bill gives the Secretary authority to provide regulations under which U.S. persons who are neither insured or reinsured by a foreign corporation (directly or indirectly), nor related to a person insured or reinsured (directly or indirectly) by the corporation will not be treated as U.S. shareholders of the foreign corporation.

It is anticipated that the Secretary will exercise this authority to provide exemptions from the captive rules for instances where it is administratively impracticable to identify noninsureds with insignificant, indirect shareholdings in foreign corporations as U.S. shareholders. Moreover, it is anticipated that the Secretary may excuse such a U.S. person from treatment as a U.S. shareholder of the captive company even if a U.S. person *can* be identified as the indirect owner of stock of a captive insurance company, if the captive stock represents an insignificant enough portion of the assets of its direct owner. For example, where a publicly traded, widely held, foreign corporation incidentally owns stock (directly or indirectly) in a foreign corporation with related person insurance income, U.S. investors who own small proportions of the stock of the first corporation and who have no relationship to the second may technically be U.S. shareholders under the statute. In these circumstances, however, it might be appropriate for regulations to exclude such investors from the definition of U.S. shareholder.

2. Insurance companies in general

Present Law

Fresh start for computing discounted unpaid losses

To take partial account of the time value of money, the Act amends subchapter L of the Code to provide for the discounting of the deduction for loss reserves of property and casualty insurance companies. Thus, the Act limits the deduction for unpaid losses to the amount of discounted unpaid losses (new sec. 846 of the Code).

In general, the new discounting provisions apply to taxable years beginning after December 31, 1986. A fresh start is provided with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted loss reserves and the discounted balances is not taken into income.

The Act provides that the fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply (generally, taxable years beginning in 1987) for purposes of calculating any adjustment to earnings and profits. The current earnings and profits of a controlled foreign corporation serve as a limitation on the amount of the corporation's subpart F income for the current taxable year.

Definition of United States risk

Section 861(a)(7) (unchanged by the Act) treats as U.S. source income amounts received as underwriting income derived from the insurance of U.S. risks as defined in section 953(a). Prior to the Act, section 953(a) defined the term "income derived from the insurance of U.S. risks" as income that would (subject to certain modifications described in section 953(b)) be taxed under subchapter L if the income were that of a domestic insurance company, and that is attributable to the reinsuring or the issuing of any insurance or annuity contract (1) in connection with property, activities, or the lives or health of individuals resident in the United States, or (2) under any arrangement where another corporation receives a substantially equal amount for covering such risks.

In connection with the Act's expansion of the subpart F tax haven insurance definition, extending current taxation to any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized, the definition of U.S. risk was no longer relevant for section 953(a) purposes. Congress did not intend to alter the substance of the related source rule in section 861(a)(7).

Allocation of insurance company expenses

In connection with prior law's shareholder-level taxation of controlled foreign corporation income from insurance of U.S. risks, the Code provided for tax on all of the underwriting income and net investment income from insuring such risks. Certain deductions generally allowed domestic insurance companies were not allowed in the case of these foreign operations, and other allowed deductions were to be taken into account only to the extent they were in respect of contracts insuring U.S. risks. All other deductions, as well as all items of income, were to be properly allocated or apportioned under regulations between income from insuring U.S. risks and income from insuring foreign risks. Under this regime, for example, the regulations generally allocated reserve deductions to underwriting income (*see* Reg. sec. 1.953-4(h)).

The Act not only imposed on U.S. shareholders current taxation on all of the controlled foreign corporation's net underwriting income from insuring foreign risks outside its home country ("non-same-country risks"), but also subjected income derived from the corporation's investments of funds generally to current U.S. taxation under subpart F, regardless of the extent to which the corporation receiving such income is engaged in the business of insuring same-country risks. Congress intended that, under the existing statute calling for regulations to allocate and apportion deductions with respect to insurance income, reserve and other deductions would be allocated and apportioned, where appropriate, to investment income so as to result in current taxation of net investment income and deferral of tax on same-country underwriting income without, in the latter case, reduction for expenses, losses, or reserves properly allocable to investment income.

Carryover of insurance company deficits

Under the Act, a U.S. shareholder's inclusion of subpart F insurance income of a controlled foreign corporation may be reduced by post-1986 accumulated deficits in that corporation's earnings and profits attributable to activities that give rise to subpart F insurance income, provided that the controlled foreign corporation receiving such income was a qualified insurance company. A qualified insurance company is a controlled foreign corporation predominantly engaged in the active conduct of an insurance business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Thus, subpart F inclusions of a qualified insurance company's investment income attributable to non-same country insurance (which is a type of subpart F insurance income) may be eligible for reduction by accumulated deficits.

A qualified insurance company's investment income attributable to *same* country insurance is generally foreign personal holding company income. Inclusions of foreign personal holding company income may sometimes be reduced by accumulated deficits under a rule similar to that for subpart F insurance income, but generally not if the income is earned by an insurance company eligible for the benefits of the insurance income deficit rule. Rather, the opportunity to reduce inclusions of foreign personal holding company income by accumulated deficits is available only if the controlled foreign corporation receiving such income was predominantly engaged in the active conduct of a banking, financing, or similar business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit.

Explanation of Provisions

Fresh start for computing discounted unpaid losses

The bill provides that for purposes of computing the earnings and profits limitation on subpart F income, current earnings and profits are determined without regard to the increase in current earnings and profits under the discounting fresh start provision of the Act. Thus, the one-time increase in current earnings and profits of a controlled foreign corporation under the discounting fresh start provision will not result in any increase in subpart F income of that corporation.

Definition of United States risk

The bill reinstates for purposes of section 861(a)(7) the pre-Act definition of income from U.S. risks. The bill treats as U.S. source income amounts received as underwriting income derived from the issuing (or reinsuring) of any insurance or annuity contract (1) in connection with property, activities, or the lives or health of individuals resident in the United States, or (2) under any arrangement where another corporation receives a substantially equal amount for covering such risks.

Allocation of insurance company expenses

The bill clarifies that regulations are to provide for the proper allocation and apportionment of all insurance company expenses, losses, and deductions between income that is subject to current U.S. shareholder taxation under subpart F (such as investment income) and income that is not (namely, same-country underwriting income). Generally, it is anticipated that amounts not specifically allocable are to be apportioned on the basis of premiums and investment income.

Carryover of insurance company deficits

The bill conforms the treatment of foreign personal holding company income of qualified insurance companies, for accumulated deficit purposes, to that of subpart F insurance income of such companies. Thus, U.S. shareholder inclusions of same country and non-same country investment income of a controlled foreign corporation predominantly engaged in the insurance business are both eligible for reduction by post-1986 accumulated deficits under the same terms. However, deficits in same country underwriting income continue to be ineligible to reduce subpart F inclusions of same country investment income and non-same country underwriting and investment income earned in later years for subpart F purposes.

3. Withdrawals of qualified shipping reinvestments that pre-Act law excluded from subpart F income

Present Law

The Act repealed the rule that, under prior law, excluded from subpart F income foreign base company shipping income that was reinvested in foreign base company shipping operations. This change was not intended to modify the taxation of withdrawals (whether by disposition of assets, adjustments to basis, or otherwise) of previously excluded subpart F income from qualified shipping reinvestments. Under the Act, the withdrawal from qualified investment for a particular taxable year is measured by reference to the excess of qualified investments as of the close of the last taxable year beginning before 1987 over the qualified investments at the close of the subsequent taxable year.

Explanation of Provision

The bill makes it clear that withdrawals of previously excluded subpart F income from qualified shipping reinvestments are to be taxed only once. For any taxable year beginning after 1986, the amount of withdrawal from qualified shipping investments for that year is limited by the bill to the excess (if any) of (1) the amount of pre-1987 qualified investments then remaining after the decreases in qualified investments determined for prior taxable years beginning after 1986, over (2) qualified shipping investments at year-end. Under this rule, post-1986 investments that meet the definition of qualified investments in foreign base company shipping operations will delay the taxation of withdrawals until all such post-1986 investments are withdrawn.

4. Definition of related person

Present Law

Whether a controlled foreign corporation's income is subject to subpart F will depend in certain cases on whether the income is received from a related person. Generally, for example, dividends, interest, royalties, and rents are subpart F income. However, rents and royalties, for example, may be excluded from subpart F income if derived in the active conduct of a trade or business and received from a person other than a related person (sec. 954(c)(2)(A)). As another example, dividends and interest may be excluded if received from certain related persons organized under the laws of the same country as the controlled foreign corporation (sec. 954(c)(3)(A)(i)).

A related person is one which controls, is controlled by, or is under common control with the controlled foreign corporation. The Act amended the definition of control for this purpose. In the case of a corporation, control means the direct or indirect ownership of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or of the total value of such corporation. In the case of a partnership, trust, or estate, control is defined as direct or indirect ownership of 50 percent or more of the total value of the beneficial interests in the entity.

Whether income is subject to the separate foreign tax credit limitation for passive income may also turn on whether it is received from a related person. The definition of the passive income basket is generally based on the definition of foreign personal holding income under subpart F, which in turn uses the concept of "related person" to provide certain exceptions from foreign personal holding company income, such as rents and royalties derived in an active business, and certain same-country dividends and interest. In addition, if a corporation is a controlled foreign corporation, payments that it makes to its U.S. shareholders may be characterized for purposes of the foreign tax credit baskets by reference to the character of the income of the controlled foreign corporation.

In contrast to the definition of control for purposes of defining a related person, the Code treats a foreign corporation as a controlled foreign corporation only if *more* than 50 percent of its stock (by vote or value) is owned (directly, indirectly, or by attribution) by U.S. shareholders. Prior to the Act, the ownership threshold for related party status was, similarly, *more* than 50 percent of the total combined voting power of a corporation's voting stock.

Different thresholds for defining "control" in the definitions of controlled foreign corporation, on the one hand, and related person, on the other, may produce unintended anomalies in the operation of the foreign tax credit limitation baskets, especially where look-through treatment may be involved. For example, assume that a foreign corporation owned 50-50 by two unrelated persons, one foreign and one U.S., derives all of its income from manufacturing, and that it pays royalties to its U.S. shareholder, which derives the royalties in the active conduct of its trade or business. This income of the shareholder is ineligible for the active royalty exception from foreign personal holding company income because the payor is a "related person." However, the foreign corporation is not a controlled foreign corporation, and therefore the royalty income of the shareholder cannot be recharacterized under the look-through rules to reflect the overall limitation character of the foreign corporation's income. Thus, the royalty is passive basket income of the shareholder, even though it would not have been if the U.S. shareholder owned either more or less than 50 percent of the foreign corporation's stock.

Explanation of Provision

The bill provides that control, for purposes of the related person definition of section 954(d)(3), means direct or indirect ownership of more than 50 percent (by vote or value) of the stock of a corporation or more than 50 percent (by value) of the beneficial interests in a partnership, trust or estate. Therefore, as was true prior to the Act, the definitions of both controlled foreign corporation and related person under subpart F are keyed to the same definition of corporate control.

In the case of royalties derived in the active conduct of a trade or business, for example, the bill prevents treatment of a 50-percent U.S.-owned foreign corporation in a manner which is different than the treatment of both foreign corporations owned more than 50 percent by U.S. persons and foreign corporations owned less than 50 percent by U.S. persons. The bill eliminates, by contrast, the opportunity for a controlled foreign corporation to exclude from foreign personal holding company income, under section 954(c)(3)(A)(i), same-country dividends from a 50-percent owned foreign corporation.

5. Treatment of gains as foreign personal holding company income

Present Law

Under the Act, the section 954(c) definition of foreign personal holding company income for subpart F purposes includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to the following types of income: first, dividends and interest; second, rents and royalties other than active business, unrelated party rents and royalties; and third, annuities.

The Act retained certain exceptions to foreign personal holding company treatment from prior law, and added new exceptions to such treatment, in connection with gains of regular dealers; gains on inventory property (sec. 1221(1)); active business gains or losses in connection with certain commodity transactions by any controlled foreign corporation substantially all of the business of which is as an active producer, processor, merchant, or handler of commodities; and foreign currency gains and losses related to the business needs of the controlled foreign corporation. For example, the Act retained prior law's subpart F exception for gains and losses of a producer, processor, merchant, or handler of a commodity which arise from bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. Congress also did not intend that net losses from the class of transactions the gains on which are covered by the regular dealer and inventory exceptions would be available to reduce foreign personal holding company income.

Explanation of Provisions

The bill adds to the category foreign personal holding company income the excess of gains over losses from sales and exchanges of interests in trusts, partnerships, and REMICs. As a corollary, these gains will generally constitute passive income for purposes of the foreign tax credit limitation.

The bill provides that the use of losses to reduce gains on sales or exchanges of property subject to foreign personal holding company treatment does not apply to loss from sales or exchanges of inventory property or from any other property by a regular dealer in that property. Thus the bill clarifies that any losses on such sales or exchanges do not reduce foreign personal holding company income.

The bill also provides a new hedging exception for regular dealers in property, under which gains and losses arising out of bona fide hedging transactions reasonably necessary to the conduct of the business of being a dealer in such property are excluded from the computation of foreign personal holding company income. Thus, where a regular dealer in bonds, for example, uses forwards, futures, options, or similar instruments in which it is not a regular dealer to hedge its exposure to losses on its bonds, the bill permits netting of gains and losses from both bonds and hedging instruments in arriving at the dealer's non-subpart F income.

6. Losses from foreign base company sales and services income

Present Law

As described in Item 2., above, the Act provided for reductions in the amount of certain types of subpart F income of a controlled foreign corporation that is included in the income of the foreign corporation's U.S. shareholders, in cases where prior year activities after 1986 (of the same type resulting in the current income) resulted in accumulated deficits in earnings and profits. The categories of income within which such reductions are available under the Act are foreign base company shipping income, foreign base company oil related income, subpart F insurance income of a qualified insurance company, and foreign personal holding company income of qualified financial institutions. For the most part, these are categories from which taxpayers were able to avoid U.S. tax on subpart F income inclusions under the pre-Act rules. For example, much of subpart F insurance income and foreign personal holding company income of qualified financial institutions was not subpart F income at all prior to the 1986 Act. Moreover, pre-Act rules on reinvestment of foreign base company shipping income made it possible to avoid income inclusions on the current income from foreign base company shipping operations.

Foreign base company sales income and foreign base company services income cannot be reduced by accumulated deficits. Since 1963, U.S. shareholders of controlled foreign corporations earning current income in these subpart F categories have been likely to be taxed currently on that income.

Explanation of Provision

The bill adds foreign base company sales income and foreign base company services income to the list of income categories the shareholder income inclusions from which are reducible by post-1986 accumulated deficits. In addition, unlike the other categories of income eligible for this treatment, the bill makes foreign base company sales income and foreign base company services income reducible by post-1962, pre-1987 accumulated deficits, to the extent those deficits were not previously taken into account. Thus, inclusions of foreign base company sales income of a controlled foreign corporation may be reduced by accumulated prior-year deficits in that corporation's earnings and profits attributable to activities that give rise to foreign base company sales income. Similarly, foreign base company services income of a controlled foreign corporation may be reduced by accumulated prior-year deficits in that corporation's earnings and profits attributable to activities that give rise to foreign base company services income.

As is true for the other categories of income entitled to similar treatment, accumulated deficits from foreign base company sales and services may be used only once, but those that cannot be utilized in one year may be carried over indefinitely for possible use in later years. To be eligible for use under the rule, an accumulated deficit must be attributable to a year for which the foreign corporation incurring such deficit was a controlled foreign corporation. Moreover, the deficit can reduce the subpart F inclusion of only those U.S. persons that were U.S. shareholders in the controlled foreign corporation when the deficit was incurred.

7. Chain deficit rule

Present Law

Prior to the 1986 Act, if a foreign corporation had a current deficit in earnings and profits, then under regulations (sec. 1.952-1(d)) a controlled foreign corporation in the same chain of ownership could have its current earnings and profits reduced for subpart F purposes to take into account that deficit. Congress repealed this so-called "chain deficit rule" in the 1986 Act.

Explanation of Provision

Under the bill, a controlled foreign corporation may reduce subpart F income from a "qualified activity" by the amount of an overall current deficit in earnings and profits attributable to losses from that activity as carried on by another corporation created or organized under the laws of the same country, if all of the stock of one of the foreign corporations (other than directors' qualifying shares, if any) is owned at all times during the taxable year in which the deficit arose, either directly or indirectly in a single chain of corporations, by the other foreign corporation. This rule is to be applied after application of the basic earnings and profits limitation on subpart F income and after taking the controlled foreign corporation's prior year qualified deficits into account. Once used in this manner, the deficit is extinguished, and cannot be used, for example, to reduce the U.S. shareholder's pro rata share of future subpart F income of the subsidiary.

Thus, where a U.S. multinational engages in one qualified activity in a foreign country, using two or more foreign corporations in a chain of ownership to do so, the current year qualified deficits of one foreign corporation may reduce the subpart F income of the other from the same qualified activity. For example, assume that a U.S. corporation owns all the stock of a banking corporation organized in a foreign country, and that the latter owns all the stock of a second banking corporation organized in the same country. The parent foreign bank has foreign personal holding company income of $100 and earnings and profits of $50. After application of the earnings and profits limitation of section 952(c)(1)(A), the parent bank has subpart F income of $50. The subsidiary foreign bank has a loss of $100 attributable to activities that, when profitable, generate foreign personal holding company income, and has a deficit in earnings and profits of $60. Under the bill, the parent foreign corporation may elect to reduce its subpart F income to zero reflecting the subsidiary's deficit.

It is believed that this provision affords taxpayers a reasonable measurement for their taxable income from foreign operations without the degree of potential for mismatching that prompted the 1986 Act's repeal of the chain deficit rule. For example, use in this provision of the "qualified activity" definition of the accumulated deficit rules (as amended by the 1986 Act) avoids the problem perceived by Congress that a loss could have eliminated U.S. tax on income earned elsewhere in the chain even though the loss might have been in a non-subpart F income category or borne little or no relation to the income it offset.

8. Measurement of earnings and profits

Present Law

As noted above, the amount of earnings and profits of a controlled foreign corporation for a taxable year serves as a limitation on the amount of its subpart F income for the year. Except as provided in section 312(k)(4), for purposes of subpart F the earnings and profits (or deficit in earnings and profits) of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations, subject to regulations.

The Tax Reform Act of 1984 introduced several provisions to make a corporation's earnings and profits more closely conform to its economic income where economic income diverged from taxable income. Under the 1984 Act, for example, a corporation using the LIFO method of accounting for inventory adjusts earnings and profits under rules designed to eliminate the impact of LIFO on earnings and profits (current sec. 312(n)(4)). A corporation's earnings and profits for a year in which the corporation sells property on the installment basis generally are to be computed as if the corporation did not use the installment method to account for the installment sale (current sec. 312(n)(5)).

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under the 1984 Act, a corporation that accounts for income and expense on this method is required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis (sec. 312(n)(6)).

The effect of these provisions is generally to accelerate the inclusion of amounts in earnings and profits, reducing to some extent amounts of earnings and profits that can be treated as current earnings in future taxable years. In the case of a domestic corporation computing taxable dividends, this reduction in subsequent years' current earnings and profits does not generally reduce the tax on amounts distributed in the subsequent year, because the distribution of accumulated earnings is also taxed.

In the case of computing the subpart F limitation, on the other hand, acceleration of earnings under these provisions generally has the effect of raising the subpart F limitation in an earlier year than the year in which those earnings would be included in taxable income of U.S. shareholders.

The Act put new limits on the amounts by which prior year deficits in earnings and profits, or deficits in non-subpart F income, can be used to reduce subpart F inclusions (sec. 952(c)). Those provisions generally do not, however, provide for increasing the earnings and profits limitation by a prior year excess of earnings and profits over subpart F income, even if those earnings and profits relate to subpart F income categories.

Explanation of Provision

Under the bill, the earnings and profits limitation on subpart F income is to be determined without regard to the rules that accelerate in some cases the recognition of earnings and profits from inventory assets accounted for under the LIFO method, from installment sales, and from contracts the income from which is accounted for under the completed contract method. By conforming the computation of earnings and profits for this purpose to the computation of taxable income, the bill ensures that subpart F income inclusions more closely match the controlled foreign corporation's taxable subpart F income. The bill thus reduces the possibility that tax haven income will go untaxed.

The modification also provides, however, that under regulations, if the earnings and profits arising from inventory assets, an installment sale, or a completed contract are distributed prior to the year that they would otherwise be included in earnings and profits for purposes of computing the earnings and profits limitation on subpart F income (e.g., the year in which the installment receivable is collected or the contract is completed), those earnings are not to be included in earnings and profits in the later year. This treatment may be necessary to eliminate the potential for those earnings to be taxed twice.

9. Effective date of accumulated earnings tax amendments

Present Law

The Act amended sections 535 and 545 to provide that the accumulated earnings tax and personal holding company tax applicable to a foreign corporation will be calculated by taking net capital gains into account when computing the net capital gain deduction only if they are effectively connected with the conduct of a U.S. trade or business, and only if they are not exempt by treaty from U.S. tax. Congress intended that the amendments apply to gains and losses realized on or after January 1, 1986, rather than only those gains and losses realized after March 1, 1986 as stated in the Act.[2]

Explanation of Provision

The bill amends the effective date of the Act's amendments to sections 535 and 545. Under the bill the Act's amendments apply to gains and losses realized on or after January 1, 1986.

10. Dividends received deduction

Present Law

The Act rewrote section 245(a), which governs the deduction for dividends received from foreign corporations, modifying it in several important respects. Under the Act, dividends eligible for the deduction are based on the ratio of (a) the foreign corporation's post-1986 earnings and profits that have been subject to net-basis U.S. corporate income tax and that have not been distributed to (b) the corporation's total accumulated earnings and profits.

The Act disallowed indirect foreign tax credits (sec. 902) to the extent the taxes are attributable to the portion of dividends from foreign corporations that is eligible for the dividends received deduction. In addition, for foreign tax credit limitation purposes, the portion of any dividend from a foreign corporation that is eligible for the dividends received deduction is treated as U.S. source.

Under section 1248, where a U.S. person sells or exchanges stock in a foreign corporation (or receives a distribution which is treated as an exchange of stock in a foreign corporation) which was, during the previous 5 years, a controlled foreign corporation in which the U.S. person was a U.S. shareholder, the gain recognized on the sale or exchange is treated as dividend income of the U.S. person to the extent of the earnings and profits of the foreign corporation attributable to such stock and accumulated since 1962 during periods in which the corporation was a controlled foreign corporation and in which the U.S. person held the stock sold or exchanged. For these purposes, certain income items, including generally amounts effectively connected with a U.S. trade or business of the controlled foreign corporation and not exempt from tax (or subject to a reduced tax rate) by treaty, are excluded from earnings and profits. Thus, amounts treated as dividends under section 1248 are generally derived from earnings not subject to U.S. corporate income tax, and therefore generally are not eligible for the dividends received deduction under the Act.

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[2] *See* H. Rep. 99-841, Vol. II (September 18, 1986), p. 628 (Conference Report).

Explanation of Provision

The bill modifies the Act's disallowance of foreign tax credits. The bill extends the potential disallowance to any foreign taxes, those eligible for the direct credit (sec. 901) as well as the indirect credit (sec. 902).

In addition, to the extent that a treaty obligation of the United States requires the United States to treat dividends from a foreign corporation that are eligible for the dividends received deduction as foreign source, the bill allows any recipient of such dividends to elect the treaty source rule, but the bill subjects the portion of dividends from that corporation that would be treated as U.S. source income absent a treaty to their own separate foreign tax credit limitation, and denies the benefits of the dividends received deduction.

An example illustrates the operation of this provision. A foreign corporation, wholly owned by a U.S. corporation, accumulates $100 of earnings and profits in 1987, of which $60 is post-1986 undistributed U.S. earnings. Because of a U.S. corporate-level tax preference, there is no U.S. corporate tax on the $60 of post-1986 undistributed U.S. earnings. An income tax treaty prevents imposition of the U.S. branch profits tax on this $60 of post-1986 undistributed U.S. earnings. The foreign country imposes $30 of corporate-level tax on this foreign corporation. Of this $30, $18 is attributable to the $60 of post-1986 undistributed U.S. earnings. The foreign corporation distributes $70 to its U.S. corporate shareholder. That $70 incurs a $7 foreign withholding tax, of which $4.20 is attributable to the $60 of pre-foreign corporate-level tax post-1986 undistributed U.S. earnings.

The tax treaty with the foreign corporation's residence country obligates the United States to treat dividends from the foreign corporation as foreign source. The taxpayer elects the treaty source rule. Of the total foreign tax of $37, 60 percent, or $22.20, is attributable to the $60 of post-1986 undistributed U.S. earnings. The U.S. pre-credit tax on that amount, at a 34-percent rate, is $20.40. The $22.20 in foreign taxes on that amount of income that are eligible for credit exceed the $20.40 U.S. tax on that amount. The $1.80 excess may be carried forward for use against the U.S. tax on future dividends out of post-1986 undistributed U.S. earnings from this foreign corporation, but not for other use. (No carryback is possible on these facts, but carrybacks could occur in other cases.) Since the taxpayer elected to apply the treaty source rule, no dividends received deduction is available with respect to that dividend.

The $40 of dividend income that is not attributable to post-1986 undistributed U.S. earnings is not affected by the bill. That $40 is treated as foreign source income under Code rules, and the $14.80 of foreign tax that is attributable to that $40 is associated with that income (and excess credits are eligible for cross-crediting against income of the taxpayer other than that attributable to the post-1986 undistributed U.S. earnings of that foreign corporation) under Code rules.

The bill also provides that for purposes of section 245(a), the term dividend does not include any amount treated as a dividend under section 1248. Thus, the bill clarifies that a taxpayer which is treated as having received dividend income due to the sale or exchange of stock in a controlled foreign corporation will not be eligible for a deduction of any portion of the amount treated as a dividend.

D. Special Tax Provisions for U.S. Persons

1. Possession tax credit (sec. 112(n) of the bill, sec. 1231 of the Reform act, and sec. 936 of the Code)

Present Law

Under present law, the possession tax credit is not allowed unless a possessions corporation satisfies a trade or business income test. This test is satisfied if 75 percent or more of the gross income of the possessions corporation in the 3-year period including the current and preceding two taxable years is derived from the active conduct of a trade of business within a possession of the United States. (For taxable years beginning after 1984 and before 1987, a 65-percent trade or business income test was imposed.)

Explanation of Provision

A possessions corporation would not be disqualified in taxable years beginning in 1987 or 1988 if: (1) it meets the 65-percent trade or business income requirement of prior law; (2) 75 percent or more of the gross income of the corporation for taxable years beginning after 1986 is trade or business income; and (3) it elects to reduce qualified possession source investment income to the extent in excess of that allowed under the 1986 Act. Income attributable to disallowed investment income would not be treated as qualified possession source investment income for any taxable year.

The bill also makes clerical amendments.

2. Effective date of provision governing transfers of intangibles to related parties (sec. 112(n) of the bill, sec. 1231 of the Reform Act, and sec. 482 of the Code)

Present Law

The Act requires that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. The new provisions carrying out this rule apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after that date (or before that date with respect to property not in existence or owned by the taxpayer on that date). For purposes of section 936, the new provisions apply to taxable years beginning after December 31, 1986, without regard to when any transfer (or license) was made.

In view of the fact that the objective of these provisions—that the division of income between related parties reasonably reflect the relative economic activity undertaken by each—applies equally to inbound transfers, Congress concluded that it would be appropriate for these principles to apply to transfers between related parties generally (via sec. 482) if income must otherwise be taken into account. However, in the case of a transfer of the type that is covered by the Act but that would not have been affected by the House version of H.R. 3838, Congress intended to apply the above effective date provision substituting "August 16, 1986" for "November 16, 1985.“

Explanation of Provision

In the case of transfers and licenses of intangibles which are not to foreign persons (and not to possessions corporations), and therefore not of the type affected by the House version of H.R. 3838, the bill modifies the relevant effective date provision of the Act. In the case of a transfer or license which is not to a foreign person or a possessions corporation, the bill provides that the Act applies to taxable years beginning after December 31, 1986, but only with respect to transfers after August 16, 1986, or licenses granted after that date (or before that date with respect to property not in existence or owned by the taxpayer on that date). The bill clarifies that for purposes of section 936, which governs income from certain intangibles whether or not the intangibles are actually transferred, the Act's provisions apply to taxable years beginning after December 31, 1986, regardless of whether a transfer (or license) was made.

3. Information returns on resident status (sec. 112(o) of the bill, sec. 1234 of the Reform Act, and sec. 6039E of the Code)

Present Law

The Act provided that an IRS information return generally must be filed in conjunction with a citizen's passport application and with a resident alien's green card application. These returns must provide the individual's taxpayer identification number (if any), information with respect to whether a green card applicant has been required to file a tax return for the individual's most recent three taxable years, and such other information as the Secretary may require. The Act further required U.S. agencies which collect (or are required to collect) the new information returns to provide them, and the names (and any other identifying information) of any individuals who refuse to provide them as required, to the Secretary.

The Immigration Reform and Control Act of 1986 became law after the Tax Reform Act of 1986. This new immigration law established a legalization program (section 245A of the Immigration and Nationality Act; 8 U.S.C. sec. 1255a). Under the program the U.S. Attorney General is to accord eligible applicants who were undocumented aliens the status of aliens lawfully admitted to the United States for permanent residence. Applicants are to provide the Justice Department with information establishing their eligibility for legalization. The new immigration law contains confidentiality rules, violation of which is punishable as a felony, that generally preclude government employees involved in the legalization program from sharing or disseminating outside the confines of the program information furnished pursuant to an application for legalization.

Explanation of Provision

The bill clarifies that the confidentiality provisions of the legalization program enacted in the Immigration Reform and Control Act of 1986 are not overridden by the previously enacted Tax Reform Act provisions requiring federal agencies to share information on green card applicants with the Secretary of the Treasury.

4. Treatment of certain passive foreign investment companies (sec. 112(p) of the bill, sec. 1235 of the Reform Act, and secs. 864, 904, 1246, 1248, and 1291-1297 of the Code)

Present Law

Overview

The Act established rules for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where each U.S. shareholder includes currently in gross income his or her share of a PFIC's total earnings, with an election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition

A passive foreign investment company (PFIC) is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income. Passive income for these purposes means generally income that is subject to the passive income separate foreign tax credit limitation (sec. 904(d)(2)(A)), without regard to the exceptions contained therein (i.e., without regard to the exceptions to passive income for income included in other separate foreign tax credit limitations, export financing interest, high-taxed income, and foreign oil and gas extraction income). Thus, for example, passive income does not include any dividend received by a corporation from a related corporation organized in the same foreign country as the shareholder if the dividend is excluded from passive income for foreign tax credit purposes. Passive assets for this purpose are those assets that produce or are held for the production of passive income. It is intended that assets that are property which, in the hands of the foreign corporation, are inventory property (as defined in sec. 1221(1)), or are held by a regular dealer in that property, be treated as nonpassive assets, even where that property generates foreign personal holding company income (as defined in sec. 954(c)), such as in the case of a securities broker-dealer that holds debt securities as inventory.

Although the Act incorporated the definition of passive income that is applied for foreign tax credit limitation purposes, it is unclear whether the look-through rules contained therein (i.e., secs.

904(d)(3) and (d)(5)), are, to the extent applicable, to be used in determining whether income is passive for PFIC purposes as well.

Exceptions to PFIC classification

In determining whether foreign corporations that own subsidiaries that are primarily engaged in active business operations are PFICs, look-through treatment is provided in certain cases. Under this look-through rule, a foreign corporation that owns at least 25 percent of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test. It is unclear under the Act whether the look-through rule applies when the 25 percent ownership is indirectly held.

Except as provided in regulations, passive income does not include income derived by a bona fide insurance company that would be subject to taxation under subchapter L if the company were a U.S. corporation. It was intended that regulations provide that entities engaged in the business of providing insurance derive passive income and, thus, may be PFICs in certain cases where the entities maintain financial reserves in excess of the reasonable needs of their insurance business.

General rule—nonqualified funds

General rule

United States shareholders in PFICs that are not "qualified electing funds" pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (Code sec. 1291). Under this rule, gain recognized on disposition of stock in a nonqualified fund or on receipt of an "excess" distribution from a nonqualified fund is treated as ordinary income and is treated as earned pro rata over the shareholder's holding period of his or her investment. It was intended that the interest charge imposed on gains and excess distributions be treated as interest for tax purposes. Distributions from nonqualified funds are not eligible for a deemed paid foreign tax credit under section 902.

Definition of excess distribution

An "excess" distribution is any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year). It is unclear whether excess distributions are included in determining any 3-year average distribution amount in respect of a share of stock.

Anti-avoidance rules

The Act, in addition to incorporating certain anti-avoidance rules in present law section 1246 (relating to foreign investment companies), provided the Secretary the authority to disregard any nonrecognition provision of present law on dispositions of PFIC stock. For example, it is contemplated that regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

Qualified electing funds

General rule

United States persons who own stock in a "qualified electing fund" must include currently in gross income their pro rata share of the PFIC's total earnings and profits. This inclusion rule requires current payment of tax, absent a shareholder-level election to defer tax. A qualified electing fund is any PFIC that properly elects with the Secretary and complies with the requirements the Secretary prescribes to determine the income of the PFIC, to ascertain its stock ownership, and to ascertain any other information necessary to carry out the purposes of those rules.

The amount currently included in income is divided between a shareholder's pro rata share of the ordinary income of a PFIC and net capital gain income of a PFIC. The characterization of income, and the determination of earnings and profits, is made pursuant to general Code rules. Pro rata share of income is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. United States persons then include in income for the period in which they hold stock in the PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

For foreign tax credit purposes, the Act provided that amounts included currently in income from a qualified electing fund are subject to the separate foreign tax credit limitation for passive income.

The Act provided that the election to be a qualified electing fund for any taxable year must be made before the fifteenth day of the third month of the following taxable year.

Election to defer current payment of tax

United States investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts included currently in income but for which no current distribution has been received. An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

Certain events cause an extension of time to pay tax on undistributed earnings to terminate. One of those events is the disposition of stock in a PFIC, which terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. It is intended that disposition for this purpose mean any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock in a qualified electing fund is to be treated as a disposition for these purposes.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor is not taxed under the rules applicable to nonqualified funds (that is, sec. 1291) if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which include any portion of the investor's holding period.

Distributions received from a PFIC in a year the PFIC is a qualified electing fund are also intended not to be taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986, and which include any portion of an investor's holding period. The section 1291 coordinating provision as it relates to distributions is intended to prevent a fund from retaining its annual income, electing to be a qualified electing fund in a subsequent year, and then distributing the accumulated income without the imposition of an interest charge.

Any U.S. person who owns stock in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

Attribution of ownership

In determining stock ownership, a U.S. person is considered to own his proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or in certain cases, a grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock. However, if a U.S. person owns any stock in a PFIC, the person is considered to own his proportionate share of any lower-tier PFIC stock owned by the upper-tier PFIC, regardless of the percentage of his ownership in the upper-tier PFIC. In attributing stock ownership, holders of options for stock of a corporation are not treated as owning the stock in the corporation.

Anti-avoidance rules

The Act provided authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent circumvention of the interest charge.

One example where regulations may be necessary to carry out the purposes of the Act's provisions is where the ownership attribution rules impute stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. In this instance, regulations are intended to treat the disposition of interests in the intervening entity as a disposition of the PFIC stock. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.

Coordination with other current inclusion and disposition rules

The Act adopted rules to coordinate the PFIC provisions with the subpart F and foreign personal holding company (FPHC) current inclusion rules in the case of qualified electing funds. Under these coordination rules, amounts required to be included in income currently under either section 951 or 551 shall be included first under those rules and then any additional amounts shall be included currently under section 1293. However, the Act did not provide for any adjustment to the amount treated as a dividend (under sec. 1248) when stock of a qualified electing fund that is also a controlled foreign corporation is disposed of and the seller has previously included (under sec. 1293) unremitted earnings of the fund in his or her income. The Act also did not provide rules that prevent in all cases the double inclusion of income earned by a controlled foreign corporation that is itself owned by another foreign corporation that is both a controlled foreign corporation and a PFIC that is a qualified electing fund. Further, the Act did not provide coordination of the PFIC provisions and the subpart F and FPHC provisions in the case of nonqualified funds.

Explanation of Provisions

Definition of passive foreign investment company

General definition

The bill conforms the PFIC definition of passive income to the definition of passive income under subpart F (sec. 954(c)). This change, in conjunction with the look-through rule for certain 25-percent-owned corporations, makes it explicit that earnings of certain related foreign corporations organized in the same country as its shareholder that, if paid as a dividend would be excluded from foreign personal holding company income under the same-country exception of subpart F (sec. 954(c)(3)), are subject to section 1296(c) look-through treatment (i.e., they are treated as earned directly by the 25-percent or greater parent corporation, and distributions of those earnings are disregarded for purposes of testing the level of the parent's passive income).

The bill also provides a set of look-through rules to characterize amounts received from related persons as passive or nonpassive income. (These new look-through rules are substantially similar to the look-through rules under the foreign tax credit provisions, which were intended to apply for PFIC purposes as well.) These PFIC look-through rules are in addition to the Act's rule that treats assets held by, and income received by, certain 25-percent-owned corporations as being held by, and received by, those corporations' shareholders (sec. 1296(c)). Under the bill's new PFIC look-through rules, interest, dividends, rents, and royalties received from related persons that are not subject to section 1296(c) look-through treatment are treated as passive income to the extent that, under regulations prescribed by the Secretary, those amounts are allocable to income of the payor that is passive income. As a corollary, the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a nonpassive asset if the interest on the loan is treated as nonpassive income. It is anticipated that the regulations will follow the approach of the foreign tax credit allocation rules in making these allocations for PFIC purposes. Thus, it is anticipated that, in the case of interest, or a payment of a rent or a royalty, the amount treated as passive will be that amount which is allocated against passive income of the payor. In the case of dividends, it is intended that the dividend be prorated between passive and nonpassive income on the basis of the passive and nonpassive earnings and profits of the payor. The bill defines a related person by reference to the related person definition in subpart F (that is, sec. 954(d)(3)).

The bill also provides an election to a foreign corporation in determining whether it is a PFIC. Under the election, a foreign corporation can apply the asset test using the adjusted bases of the corporation's assets, rather than the fair market value of its assets, in determining whether it is a PFIC. Under this election then, a foreign corporation with less than 50 percent passive assets by adjusted basis will not be a PFIC (assuming the income test is not met), even if its assets are 50 percent or more passive by fair market value. It is anticipated that the Secretary will prescribe regulations concerning the time and manner of making such an election. The election, once made, is revocable only with the consent of the Secretary.

Exceptions to PFIC classification

The bill clarifies that the look-through rule for 25-percent-owned corporations (under sec. 1296(c)) applies to direct or indirect 25-percent ownership that is held by an upper-tier foreign corporation.

The bill also clarifies the exception from passive income for income received by bona fide insurance companies. This exception from passive income extends only to income derived by insurance companies that are predominantly engaged in the active conduct of an insurance business and that would be taxed under the special rules applicable to domestic insurance companies if they were domestic corporations. Thus, income derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business.

The bill further treats stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation as a non-passive asset. Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, will be treated as owning nonpassive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign investment company attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company will be subject to tax treatment essentially equivalent to that of the shareholders of PFICs.

Nonqualified funds

The bill makes several modifications and clarifications to the rules applicable to PFICs that are not qualified electing funds.

General rule

The bill clarifies that the interest charge imposed on excess distributions received from, and on gains derived from the sale of stock in, a nonqualified fund is treated as interest for tax purposes.

The bill also repeals the Act's provision which denies U.S. corporate shareholders in PFICs that are not qualified electing funds benefit of the indirect foreign tax credit under section 902. Thus, if a U.S. corporation owns at least 10 percent of the voting stock in a PFIC, the corporation is treated as paying its share of the PFIC's foreign income taxes imposed on the earnings the PFIC distributes to the U.S. corporation. It is anticipated that appropriate adjustments to the section 902 rules will be made in the case of excess distributions.

Definition of excess distribution

The bill modifies the determination of an excess distribution to exclude from the 3-year average distribution amount that part of an excess distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that is not allocable to pre-PFIC years and to the current year). This modification is necessary to prevent the avoidance of the interest charge that would otherwise be due on accumulated earnings. For example, a PFIC could accumulate earnings for a period of years, and then distribute those earnings ratably over a period greater than three years. If the excess distributions received in the first three years were to be included in the 3-year average distribution amount, distributions received after three years would not be excess distributions, and hence no interest would be imposed on the deferred earnings inherent in those later distributions.

The bill clarifies the determination of a taxpayer's holding period as it relates to receipt of an excess distribution. This clarification provides that a taxpayer's holding period is considered to end on the date of receipt of an excess distribution but only with respect to that distribution. Thus, the taxpayer's holding period in its stock to which the excess distribution is attributable does not end on the date of receipt of the excess distribution.

Anti-avoidance rules

The bill clarifies that the regulatory authority provided under the Act to deny the benefits of any nonrecognition treatment extends to any transfers of PFIC stock, including transfers at death or by gift.

Qualified electing funds

The bill also modifies and clarifies the rules applicable to PFICs that are qualified electing funds.

General rule

The bill provides that, to the extent provided in regulations, if a qualified electing fund establishes to the Secretary's satisfaction that it maintains records that determine investors' pro rata shares of income more accurately than allocating a taxable year's income ratably over a daily basis (for example, by allocating a month's income ratably over a daily basis), the fund can determine the investors' pro rata shares of income on that basis. This provision is designed to allow those funds that maintain appropriate records to more accurately determine U.S. investors' pro rata shares of income, which may be important in cases where the investors own their stock for only parts of a year. For example, if a PFIC maintains records on a monthly basis and allows redemptions and acquisitions of its stock only at a month's end, this provision would allow U.S. investors to include in income amounts actually earned by the PFIC for each month rather than including in income under the general rule a ratable share of the year's total income.

The bill modifies the determination of a PFIC's earnings and profits in two respects. The first modification provides that earnings and profits are computed using the installment method of accounting (and the completed contract method of accounting and the LIFO inventory method, if applicable) if a PFIC is permitted to and in fact does use the method to compute its income. For example, if a PFIC uses the installment method of accounting in computing its income, U.S. investors' pro rata shares of income will take into account that method. This modification only affects earnings and profits for income inclusion purposes. Thus, it does not change earnings and profits for purposes of determining, for example, if a distribution is a dividend. The modification also provides, however, that, under regulations, if the earnings and profits arising from the installment method and considered deferred for income inclusion purposes are distributed prior to the year that they would otherwise be included in income (e.g., the year in which the installment receivable is collected), those earnings are not to be included in income in the later year. This latter rule is necessary to eliminate the potential for double taxation of those earnings.

The second modification applies only when the qualified electing fund is also a controlled foreign corporation and the U.S. investor in the fund is also a U.S. shareholder in the controlled foreign corporation (as both terms are defined under subpart F). Under this modification, if the U.S. investor establishes to the satisfaction of the Secretary that an item of income derived by a fund was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of U.S. corporate tax, then that item of income is excluded from the ordinary earnings and net capital gain income of the fund for purposes of determining the U.S. investor's pro rata share of income. It is anticipated that, as with the parallel rule in subpart F (sec. 954(b)(4)), regulations will be prescribed to allow grouping of items of income in appropriate cases. It is further anticipated that regulations will be prescribed to segregate earnings between earnings that have been included currently in income and earnings that have not been so included (because they are highly taxed) and to prescribe ordering rules for characterizing distributions of these earnings.

The bill also provides regulatory authority to insure that the same item of income of a qualified electing fund will not be included in the gross income of a U.S. person more than once. One case where relief is anticipated is where a U.S. person owns stock in a foreign corporation that is a PFIC and a controlled foreign corporation, and the foreign corporation in turn owns stock in a second foreign corporation that is not a PFIC but is a controlled foreign corporation. For example, assume in this case that the PFIC elects to be a qualified electing fund, the U.S. person's stock ownership in both foreign corporations is such that it is a U.S. shareholder in the corporations, and the second-tier controlled foreign corporation derives subpart F income that is included currently in the income of the U.S. person. Under the Act, when the second-tier controlled foreign corporation distributes its earnings, the PFIC's ordinary earnings, which will be included in the U.S. person's income as well as any other U.S. investors' incomes, will include the subpart F income that the U.S. person has included previously in income under subpart F, thus resulting in that income being included twice. In this case, it is intended that regulations coordinate these provisions to prevent the double inclusion. For example, regulations may provide that the subpart F income distributed by the second-tier controlled foreign corporation is, for income inclusion purposes, to be excluded from the qualified electing fund's ordinary earnings on a shareholder-by-shareholder basis.

The bill further modifies the Act's rules in characterizing income inclusions from qualified electing funds for foreign tax credit purposes. In the case of a qualified electing fund that is also a controlled foreign corporation, where the U.S. person that has the income inclusion is a U.S. shareholder in the corporation (as defined under the subpart F rules), look-through treatment determines the foreign tax credit limitation characterization of the income inclusion. In addition, where the qualified electing fund is a noncontrolled section 902 corporation (as defined in sec. 904(d)(2)(E)) with respect to the taxpayer, the income inclusion is treated for foreign tax credit purposes as a dividend, and thus, is subject to the separate limitation applicable to those dividends. Where neither of the above conditions is satisfied, the income inclusion is characterized as passive income for foreign tax credit purposes.

The bill also provides regulatory authority to allow the election to be a qualified electing fund to be made at a time later than the general time period required by the Act. This authority is limited, however, to cases where the foreign corporation failed to make a timely election because the corporation reasonably believed that it was not a PFIC for the year for which the election should previously have been made. A corporation may reasonably believe that it is not a PFIC for a taxable year, for example, where the corporation makes a reasonable valuation of its assets, which shows that the corporation does not meet the 50 percent passive asset threshold, while in a later year the Internal Revenue Service on audit determines that the corporation did meet the passive asset threshold. In this case, it may be appropriate for regulations to allow the corporation to make a retroactive qualified electing fund election.

The bill also delays the general time period by which an election to be a qualified electing fund must be made. Under this provision, the general time period by which to make the election shall in no event expire before 60 days after the date of the enactment of the technical corrections bill to the 1986 Act.

Election to defer current payment of tax

The bill clarifies that disposition, for purposes of determining whether an extension of time to pay tax on undistributed PFIC earnings terminates, means any transfer of stock, regardless of whether it would give rise to a realization or recognition event under general Code rules. For example, a transfer of stock by gift causes a termination of all prior extensions of time to pay tax for the earnings attributable to that stock.

The bill provides for another event that terminates an extension of time to pay tax on undistributed PFIC earnings. This provision is designed to reflect the Act's policy that tax on an income inclusion should be payable when the shareholder receives the income from the PFIC. Under this provision, if the PFIC lends money or other property, directly or indirectly, to the U.S. investor, the loan is treated as a distribution and the extension of time to pay tax on the undistributed PFIC earnings to which the loan is attributable is terminated. In addition, the deemed distribution will, to the extent an actual distribution would not be taxed, reduce the shareholder's PFIC stock basis and the subsequent actual distribution of those earnings generally will be treated as a distribution that is not a dividend to the extent the shareholder establishes that fact with the Secretary. An indirect loan may occur under this provision where the PFIC lends property to a U.S. corporation in which the U.S. person owns, for example, a 50-percent interest. An indirect loan may also occur under this provision where the PFIC guarantees a loan by a third person to its U.S. investor or where the PFIC pledges its assets as surety for a loan by a third person to its U.S. investor.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

The bill clarifies that the deferred tax and interest charge rules of section 1291 do not apply to any distribution received by a taxpayer from a PFIC if the PFIC is a qualified electing fund for all of its years beginning after 1986 for which it is a PFIC and which include any part of the taxpayer's holding period. This treatment parallels the rule for dispositions provided under the Act.

The bill also modifies the Act's rule that allows a shareholder in a nonqualified fund to elect to recognize the gain inherent in the value of his or her stock owned in the PFIC where the PFIC becomes a qualified electing fund. Under this modification, instead of recognizing the entire gain in the value of his or her stock, a U.S. person that holds stock (directly or indirectly under the attribution rules) in a controlled foreign corporation (as defined for subpart F purposes) that is a PFIC and that becomes a qualified electing fund can elect to include in gross income as a dividend his or her share of the corporation's earnings and profits accumulated after 1986 and since the corporation was a PFIC. Upon this election, the U.S. person's stock basis is increased by the amount included in income and the shareholder is treated as having a new holding period in his or her stock. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds. The bill also makes it explicit that the total amount treated as a dividend under the above election is an excess distribution and is to be assigned, for purposes of computing the deferred tax and interest charge, to the shareholder's stock interest on the basis of post-December 31, 1986 ownership.

Attribution of ownership

The bill provides that under regulations any person who has an option to acquire stock shall be treated as owning the stock. It is anticipated that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest.

Anti-avoidance rules

The bill also provides that under regulations if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, any distribution of money or other property to the actual holder of the stock is treated as a distribution to the U.S. person. It is anticipated that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest. In these cases, the bill also provides that the amounts deemed distributed to the U.S. person are not to be included in gross income (or, in the case where the holder is a PFIC that is a qualified electing fund, in the ordinary earnings) of the holder actually receiving those amounts for purposes of causing the U.S. person to include those amounts in income again.

The bill also provides regulatory authority for the Secretary not to treat the pledge of stock in a PFIC as a disposition of that stock. For example, it is anticipated that regulations may provide that a pledge in effect prior to 1987 shall not be treated as a disposition.

Coordination with other current inclusion and disposition rules

The bill provides additional rules to coordinate the rules applicable to PFICs that are also controlled foreign corporations or foreign personal holding companies. First, in the case of a PFIC that is a qualified electing fund, the bill provides that the amount of income treated as a dividend on a sale or exchange of stock in a controlled foreign corporation (under sec. 1248) does not include any amount of income included previously under the qualified electing fund rules to the extent that that amount of income has not been distributed from the PFIC prior to the sale or exchange of the stock.

Second, the bill provides that, in the case of a PFIC that is a qualified electing fund and that owns stock in a second-tier PFIC that is also a qualified electing fund, amounts distributed by the second-tier fund to the first-tier fund that have been included previously in income by U.S. investors—because they are deemed to own stock in the second-tier fund—are not to be included in the ordinary earnings of the first-tier fund. This rule prevents U.S. persons from including amounts in income twice. This relief provision also applies in the case of a second- (or lower-) tier PFIC that is a qualified electing fund and that is also a controlled foreign corporation. In this case, amounts that are included in a U.S. person's income under the subpart F provisions and that would have been included under the qualified electing fund provisions (but for the coordination provision of sec. 951(f)) are prevented from being included in income again under this relief provision.

Third, in the case of a PFIC that is not a qualified electing fund, the bill eliminates the potential for double taxation by providing for proper adjustments to excess distributions for amounts that are taxed currently under the Code's other current inclusion rules. Thus, for example, excess distributions will not include any amounts that are treated as previously taxed income under section 959(a) when distributed by a controlled foreign corporation that is also a PFIC that is not a qualified electing fund.

The bill also makes clerical and conforming amendments to the Act's PFIC provisions.

E. Treatment of Foreign Taxpayers

1. Branch profits tax (sec. 112(q) of the bill, sec. 1241 of the Reform Act, and secs. 26, 861, 884, 904, 906, and 2104 of the Code)

Present Law

Overview

The Act imposed branch-level taxes on profits of foreign corporations operating businesses in the United States and on interest paid or deducted by U.S. businesses operated by foreign corporations. The Act also reduced the U.S. business threshold that triggers the withholding tax on dividends paid by foreign corporations (applicable where the branch profits tax cannot be applied).

Branch profits tax

A tax of 30 percent is imposed on a foreign corporation's "dividend equivalent amount." The "dividend equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments (detailed below). The determination of effectively connected earnings and profits is made without reduction for dividend distributions made by a foreign corporation during a year, so that tax is imposed on a foreign corporation that has current earnings (which are not reinvested in a branch's trade or business, as detailed below).

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted in two circumstances. These adjustments identify changes in a branch's U.S. net equity (the difference between a branch's assets that are treated as connected with its U.S. trade or business and its liabilities that are so treated) that reflect profit remittances during a taxable year. The first adjustment to the dividend equivalent amount reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce trade or business liabilities). This reduction is measured by the increase in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year and (2) the excess of the money and adjusted basis of its assets over its liabilities at the end of the preceding year. The second adjustment increases the tax base to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation. This adjustment is measured by the reduction in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the preceding year and (2) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year. The increase in the tax base because of a decrease in U.S. net equity was intended to be limited to the amount of prior earnings that have not previously been remitted to the home office.

Branch-level interest tax

Interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. It is intended that where this interest is paid to a U.S. person or a U.S. trade or business of a foreign person, the interest is also to be treated as U.S. source but not subject to withholding since it is subject to tax on a net income basis in the hands of the recipient. To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is also subject to the 30-percent tax, absent a specific Code exemption or treaty reduction.

For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable income tax treaty is the one between the United States and the country of the corporation's home office, subject, however, to the prohibition against treaty shopping. In the case of U.S. withholding tax on interest actually paid by a branch to a foreign recipient, the appropriate treaty will be that between the United States and the country of the recipient, subject again to the prohibition against treaty shopping.

Relationship with tax treaties

The Act provided that the branch profits tax is to yield to treaties only in two cases. The first case is where a foreign corporation with a U.S. branch is a "qualified resident" of a country in which the corporation is a resident (i.e., the corporation is not treaty-shopping) and the treaty prohibits the branch profits tax. The second case is where a foreign corporation resides in a country whose treaty permits the United States to impose its withholding tax on dividends paid by the corporation but otherwise prohibits the branch profits tax, whether or not the foreign corporation is treaty shopping. In this second case, however, the foreign corporation paying the dividends cannot claim any treaty benefits (i.e., reduced rates) with respect to the dividends it pays if it is treaty shopping. The Act also prohibited any foreign corporation that receives a dividend from another foreign corporation from claiming any treaty benefits with respect to the dividends received if it is treaty shopping.

A foreign corporation generally is treaty shopping in two cases: First, treaty shopping occurs if more than 50 percent (by value) of the stock of the foreign corporation is owned (determined by looking through corporations, partnerships, estates, and trusts to ultimate individual ownership) by individuals who are not residents of the treaty country. U.S. citizens and resident aliens are treated as residents of the treaty country for this purpose.

Second, where 50 percent or more of a foreign corporation's income is used to meet liabilities to persons who are not residents of the country in which the corporation is a resident or of the United States, then the corporation is treaty shopping (a "base erosion" rule).

If a foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, then the corporation is considered a qualified resident of that country. Similarly, if a foreign corporation's parent is organized in the same country as its subsidiary corporation, and the parent corporation's shares are primarily and regularly traded on an established securities market in that country, then the subsidiary corporation is considered a qualified resident of the country for purposes of the country's treaty with the United States. Under the Act, the publicly-traded exception does not automatically treat a foreign corporation that is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States as a qualified resident of the country in which it is a resident. A domestic corporation in this instance has to determine (in addition to meeting the base erosion rule) if it is more than 50-percent owned by either U.S. residents or residents of the country of the domestic corporation's subsidiary in order to be treated as a qualified resident.

Other rules

The Act reduced to 25 percent prior law's business income threshold for imposition of the withholding tax on dividends. The Act also provided that the withholding tax on dividends is not applicable where the branch profits tax generally may be imposed, even though no branch tax may be due in a particular taxable year.

For U.S. branches of foreign corporations that have undistributed accumulated earnings and profits as of their first taxable year beginning on or after January 1, 1987, the branch profits tax provisions are intended to apply only to earnings and profits generated in taxable years beginning after December 31, 1986, that are considered distributed from the branch to the home office (limited by post-effective date earnings and profits). Prior law's withholding tax on dividends is intended to apply to the pre-effective date accumulated earnings and profits that are distributed after the effective date. Thus, if a branch's income did not constitute at least 50 percent of the corporation's income for the base period prescribed under prior law, there is no withholding tax imposed on dividends paid in, for example, 1987 that represent pre-effective date earnings. Similarly, pre-effective date deficits in earnings and profits are not intended to be eligible to reduce post-effective date earnings in applying the branch profits tax. Post-effective date deficits in earnings and profits do not reduce pre-effective date earnings in applying prior law's withholding tax to distributions after 1986 where the distributions are attributable to pre-effective date earnings.

Explanation of Provision

Branch profits tax

The bill clarifies that the dividend equivalent amount is limited to the post-1986 accumulated effectively connected earnings and profits of the U.S. branch that have not previously been remitted to the branch's home office.

The bill provides that for purposes of determining a foreign corporation's dividend equivalent amount, effectively connected earnings and profits do not include the increase in earnings and profits under the discounting fresh start provision of the Act. (See Part XII.C.2., above, for further discussion of the fresh start provision.) Thus, the one-time increase in current earnings and profits of a foreign corporation under that provision will not result in any increase in branch tax. Moreover, the bill excludes from the dividend equivalent amount earnings and profits arising from the adjustment that was required by the Act to the unearned premium reserves outstanding at the end of the most recent taxable year beginning before January 1, 1987. (See Part X.3., above, for further discussion of this adjustment.)

Branch-level interest tax

The bill clarifies that, as a general rule, interest paid or deducted by a U.S. trade or business of a foreign corporation is U.S. source, regardless of the recipient. Thus, if the recipient is a foreign person not engaged in a U.S. trade or business the interest will be subject to U.S. withholding tax; if the recipient is a U.S. person or a foreign person engaged in a U.S. trade or business and the interest is effectively connected therewith, the interest will not be subject to withholding but will be subject to U.S. tax in the hands of the recipient on a net income basis. The bill further clarifies that this source rule also applies to interest payments by any foreign corporation that has gross income that is treated as effectively connected with a U.S. trade or business, for example, by an election under sec. 882(d).

The bill also modifies the taxation of interest paid by a U.S. trade or business. First, the bill excludes interest paid by international organizations (as defined in sec. 7701(a)(18)) from the scope of the provision. Second, to the extent provided in regulations, the bill will limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be deducted in arriving at the branch's effectively connected taxable income.

Relationship with tax treaties

The bill modifies the applicability of the branch profits tax in cases of treaty shopping. This modification provides that if a foreign corporation is treaty shopping, the branch profits tax will be imposed, regardless of whether the treaty with the United States and the country in which the corporation is a resident allows the United States to impose its withholding tax on dividends. One of the reasons Congress enacted the branch profits tax was the difficulty of administering prior law's withholding tax. The Act's rule—prohibiting the imposition of the branch profits tax in cases where a treaty permits the U.S. withholding tax on dividends paid by a foreign corporation whether or not the corporation is treaty shopping—would not in some cases remedy that concern. For example, assume a treaty with the United States prohibits the branch profits tax but it permits the withholding tax on dividends if the corporation derives 50 percent or more of its income from the United States. Assume further that the foreign corporation organized in this treaty country is treaty shopping. The result of the Act would be to impose the withholding tax on dividends in the years in which the corporation derives 50 percent or more of its income from the United States and to impose the branch profits tax in years in which the corporation's U.S. income is below that level. This result would be difficult to administer and would lead to tax avoidance techniques.

More importantly, however, Congress was concerned that foreign persons resident in one country would attempt to use another country's tax treaty with the United States to avoid the branch profits tax. The bill addresses this concern by not allowing treaties to prevail in treaty shopping cases.

The bill clarifies that the prohibition against treaty shopping of a foreign corporation with respect to interest paid or deducted by its U.S. trade or business applies to any person attempting to claim benefits under the interest articles of the treaty of the country in which that foreign corporation is a resident. The bill continues to allow, however, the recipient to claim benefits under the treaty in the country in which the recipient is a resident, unless the recipient is treaty shopping as well.

The bill modifies the definition of treaty shopping in two respects. First, the bill provides that if nonresidents of a treaty country own *50 percent or more* of the value of stock of a corporation the corporation is considered treaty shopping. This modification generally accords with the ownership limitation in recent U.S. income tax treaties. Second, the bill modifies the publicly traded exception to treaty shopping to provide that a foreign corporation that is wholly owned by a domestic corporation whose stock is primarily and regularly traded on an established securities market in the United States is to be treated as a qualified resident of its country of residence. This modification accords with the Act's presumption that corporations whose stock is primarily and regularly traded on a local securities market is more than 50 percent owned by local residents and with the Act's treatment of U.S. persons as treaty-country residents.

Other rules

The bill clarifies that the withholding tax on dividends is not imposed for any taxable year with respect to dividends paid out of earnings and profits of the corporation for that year if the branch profits tax may be imposed for that year (even if no branch profits tax may be due in that year). Thus, the withholding tax on dividends may be imposed in two cases. First, the withholding tax may be imposed on dividends that are attributable to pre-1987 earnings and profits. Second, the withholding tax may be imposed on dividends that are attributable to any earnings and profits when the branch profits tax is prohibited by a treaty with the United States, regardless of when the dividends are distributed. Thus, in this latter case, the withholding tax on dividends may be imposed in a year a foreign corporation is subject to the branch profits tax if the dividends are attributable to years in which the branch tax is prohibited, for example, by a treaty.

The bill also makes clerical and conforming amendments.

2. Excise tax on insurance premiums paid to foreign insurers and reinsurers (sec. 112(q)(13) of the bill and sec. 4373 of the Code)

Present Law

In certain cases, an excise tax is imposed (sec. 4371) on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership, or a U.S. resident individual, with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States. The excise tax is imposed at the rate of (1) 4 cents on each dollar (or fraction thereof) of the premium paid on a policy of casualty insurance or indemnity bond; (2) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of a life, sickness, or accident insurance, or annuity contract on the life or hazards to the person of a U.S. citizen or resident, unless the insurer is subject to tax under section 842(b) (relating to the taxation of foreign insurance companies); and (3) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

Present law (sec. 4373) provides exemptions from the excise tax in the case of policies signed or countersigned by an officer or agent of the insurer in a State or the District of Columbia, within which such insurer is authorized to do business.

The excise tax may be waived under certain U.S. tax treaties, as it is in the United States-United Kingdom Income Tax Treaty and the United States-France Tax Treaty. Although premiums received by certain persons may be exempt from the excise tax (whether by treaty or by statutory exception), such exceptions generally do not waive the excise tax for subsequent reinsurance transactions covering insurance of U.S. risks under which premiums are paid to and received by a nonexempt person. The U.S.-U.K. treaty does not follow this latter approach, however.

Explanation of Provision

The bill exempts any amount which is effectively connected with the conduct of a trade or business within the United States from the excise tax on insurance and reinsurance policies, unless that amount is exempt from net-basis taxation pursuant to a treaty obligation of the United States. Thus, for example, if a treaty prevents the United States from imposing net-basis tax on insurance income of a foreign person unless that foreign person maintains a permanent establishment in the United States, then any premium paid to a foreign person who does not have a permanent establishment in the United States will be subject to the gross-basis excise tax, unless a treaty prevents imposition of the gross-basis tax.

This provision is effective for premiums paid after 30 days after the date of enactment. No inference is intended about the effect of this provision on existing law.

3. Treatment of deferred payments and appreciation arising out of business conducted within the United States (sec. 112(r) of the bill, sec. 1242 of the Reform Act, and sec. 864(c) of the Code)

Present Law

The Act provides that any income or gain of a nonresident alien individual or foreign corporation for any taxable year which is attributable to a sale or exchange of property, the performance of services, or any other transaction, in any other taxable year shall be treated as effectively connected with the conduct of a trade or business within the United States if it would have been so treated if such income or gain were taken into account in such other taxable year (new sec. 864(c)(6)). Similarly, the Act provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of such property occurring within 10 years after such cessation is effectively connected with the conduct of a trade or business within the United States shall be made as if such sale or exchange occurred immediately before such cessation (new sec. 864(c)(7)). Under the Act, the amount of income or gain taken into account under the latter provision is not limited to the appreciation of the property while the property was used in the United States, but rather is based on the amount of income or gain recognized at the time of the sale or exchange.

A foreign corporation engaged in a trade or business during the taxable year is taxable on a net basis on its income which is effectively connected with the conduct of a trade or business within the United States (sec. 882(a)). The same treatment applies to nonresident alien individuals (sec. 871(b)).

Explanation of Provision

In the case of payments for sales or exchanges of property, the performance of services, or any other transaction, that are deferred from one taxable year to a later taxable year, the determination whether such income or gain is taxable on a net basis (under sec. 871(b) or 882(a)) is to be made as if the income were taken into account in the earlier year and without regard to the requirement (of sec. 871(b) or 882(a)) that the taxpayer be engaged in a trade or business within the United States during the later taxable year. The bill makes a similar amendment to the Act's provision taxing dispositions of property formerly used or held for use in connection with the conduct of a trade or business within the United States and disposed of within 10 years after that cessation of use. For this purpose, the property is treated as being sold or exchanged immediately before it ceased to be used or held for use in connection with the conduct of a trade or business in the United States, and the requirement (of sec. 871(b) or 882(a)) that the taxpayer be engaged in a trade or business within the United States during the taxable year for which such income or gain is taken into account is disregarded.

4. Withholding tax on amounts paid by partnerships to foreign partners (sec. 112(s) of the bill, sec. 1246 of the Reform Act, and secs. 872, 882, and 1446 of the Code)

Present Law

Partnership withholding

Prior to the Act, partnerships that conducted a trade or business in the United States generally were not required to withhold U.S. tax on distributions to foreign persons that were attributable to the U.S. business income of the partnership. Under the Act, however, partnerships must withhold in these circumstances. This withholding requirement supplements other withholding requirements applicable to certain generally passive types of U.S. source income derived by partnerships that have foreign partners.

Under the Act, the following withholding rules apply to distributions to foreign partners in U.S. or foreign partnerships that have any income effectively connected with the conduct of a U.S. trade or business. First, withholding at 30 percent (sometimes reduced or eliminated under treaties) is required with respect to distributions attributable to certain U.S. source fixed or determinable annual or periodical income not effectively connected with the conduct of a U.S. trade or business. It is intended that any distribution by the partnership be considered to come first out of these types of income received by the partnership.

Second, any partnership distribution in excess of the amounts described immediately above is subject to withholding at a 20-percent rate. The amount withheld is creditable against the U.S. income tax liability of the foreign partner. Amounts withheld in excess of a foreign person's tax liability are treated as an overpayment of tax.

Third, if a partnership's gross income effectively connected with a U.S. trade or business over a three-year period (or shorter period if the partnership is not in existence for three years) is less than 80 percent of the total gross income of the partnership over that period, then withholding is required only on the proportion of current distributions that the partnership's gross income effectively connected with its U.S. trade or business bears to the partnership's total gross income over its previous three taxable years (or shorter period if the partnership is not in existence for three years).

Fourth, the Act provides that, unless otherwise provided in regulations, withholding is not required if substantially all of the U.S. source income and substantially all of the income effectively connected with a partnership's U.S. trade or business is allocable to U.S. partners pursuant to a valid special allocation under section 704(b) and the regulations thereunder. This provision exempting amounts from withholding is not intended to apply to a partnership which has only U.S. source income and in which foreign persons hold only a minority interest such that, on a straight allocation, "substantially all" of the partnership's income could be considered to be allocated to U.S. persons. Instead, it is intended to apply only to a partnership which specially allocates its U.S. source income to U.S. persons and its foreign source income to foreign persons.

Taxation of foreign persons

Nonresident alien individuals and foreign corporations generally are subject to U.S. tax only on their gross income which is derived from U.S. sources and which is not effectively connected with the conduct of a trade or business in the United States and on their gross income which is effectively connected with the conduct of a trade or business in the United States (secs. 872(a) and 882(b)). United States tax on the former type of gross income generally is collected by withholding whereas U.S. tax on the latter type of gross income generally is collected by the filing of a U.S. tax return and payment of estimated taxes.

Explanation of Provision

Partnership withholding

The bill replaces the Act's withholding provision with a provision imposing U.S. withholding tax on partnerships in amounts equal to U.S. tax on foreign partners' distributive shares of effectively connected income. Because the Act has the potential to impose a withholding tax on distributions that include little, or in some cases no, income that would be subject to U.S. tax, a provision that accomplishes the objectives of the Act more accurately and that results in less overwithholding is more appropriate.

The bill provides that if a partnership, whether domestic or foreign, has "effectively connected taxable income" for any taxable year, and any of this income is allocable to any foreign partner under section 704, the partnership shall pay a withholding tax in the manner and at the time prescribed by regulations. The amount of the withholding tax is the applicable percentage (which is dependent on the corporate or noncorporate status of the foreign partners) of the effectively connected taxable income of the partnership that is allocable to foreign partners. For this purpose, the applicable percentage is the highest rate of U.S. tax to which each foreign partner is subject.

The bill provides that effectively connected taxable income is the partnership's taxable income, as computed under Subchapter K, with the following adjustments: (1) items that normally are separately stated for Subchapter K purposes (i.e., items described in sec. 702(a)) are included if they give rise to income that is effectively connected (or is treated as effectively connected); (2) the partnership is allowed a cost depletion deduction; and (3) any other item of income, gain, loss, or deduction is not taken into account to the extent the item is included in the distributive share of any U.S. partner. (Since this withholding tax is being computed and imposed at the partnership level, any other deduction, such as percentage depletion, that is not taken into account in arriving at effectively connected taxable income that a foreign partner is entitled to can still be claimed by the foreign partner.)

The bill further provides that each foreign partner is to treat its share of the tax paid by the partnership as a credit against its tax liability for the partner's taxable year in which (or with which) the partnership's taxable year (for which the tax was paid) ends. Moreover, the amount of credit allocable to a foreign partner is treated as distributed to the partner on the last day of the partnership's taxable year for which the tax was paid, thus reducing the partner's basis in the partnership.

Further, the bill provides the Secretary the authority to prescribe regulations necessary to carry out the purposes of the provision. For example, special rules may be necessary in identifying a publicly traded partnership's partners as U.S. or foreign. In addition, rules may be necessary in the case of tiered partnerships to prevent the imposition of more tax than will be properly due (for example, rules to prevent the tax from being imposed on more than one partnership and rules to determine the applicable percentages).

The bill's provisions are effective for taxable years beginning after December 31, 1987. Any amount that would otherwise be required to be deducted and withheld under section 1446 is no longer so required.

Taxation of foreign persons

The bill clarifies the meaning of gross income for nonresident alien individuals and foreign corporations. Under the bill, sections 872(a) and 882(b) are modified so that, for those persons, unless the context clearly indicates otherwise, gross income includes only gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and gross income which is effectively connected with the conduct of a trade or business within the United States. For example, when the taxpayer at issue is a nonresident alien individual or a foreign corporation, gross income subject to direct U.S. income tax includes only that gross income which is derived from U.S. sources and which is not effectively connected with the conduct of a U.S. trade or business and that gross income which is effectively connected with the conduct of a U.S. trade or business.

5. Income of foreign governments (sec. 112(t) of the bill, sec. 1247 of the Reform Act, and secs. 892 and 893 of the Code)

Present Law

The Act provides that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments is not included in gross income and is exempt from income taxation (sec. 892). In addition, the Act provides that the exemption does not apply to any income received from or by a controlled commercial entity. The Act's legislative history indicates that, for treaty purposes, a foreign government is to be treated as a resident of its country, unless it denies similar treaty benefits to the United States.

In certain cases, wages, fees, or salary of an employee of a foreign government received as compensation for official services to such government is excluded from gross income and is exempt from income taxation (sec. 893).

Explanation of Provision

The bill makes it clear that the Code provision benefiting certain income of foreign governments (sec. 892) neither excludes from gross income nor exempts from tax income derived from the disposition of any interest in a controlled commercial entity. Thus, this Code provision does not benefit such income, whether or not such income is received from investments in the United States in stocks, bonds, or other domestic securities owned by a foreign government. Such income may not be taxable for independent reasons: for example, a sale of stock of a U.S. corporation that is not a U.S. real property interest by a foreign person may not be subject to tax under general Code rules. For this purpose, however, a commercial entity is to include any U.S. real property holding corporation (sec. 897(c)(2)).

In addition, the bill clarifies that the Code's exclusion from gross income and exemption from taxation do not apply to income received indirectly from a controlled commercial entity (as well as to income received directly from such an entity). For example, assume that a foreign government owns all the shares of a U.S. holding company that owns all the shares of a U.S. operating company. The U.S. holding company deducts all the dividends it receives from the operating company by virtue of the 100-percent dividends received deduction. Under the bill, dividends from the holding company to the foreign government are not exempt, because they are received indirectly from a controlled commercial entity.

The bill codifies the rule that a foreign government, for income tax treaty purposes,-is treated as a corporate resident of its country if it grants equivalent treatment to the U.S. government. In addition, for purposes of the Internal Revenue Code, a foreign government is treated as a corporate resident of its country (whether or not it treats the U.S. government as a U.S. resident).

The bill conforms the gross income exclusion and tax exemption for wages, fees, or salary of an employee of a foreign government to the exclusion and exemption for governments themselves. Under the bill, the exclusion and exemption are not available to an employee of a foreign government whose services are primarily in connection with a commercial activity (whether within or outside the United States) of the foreign government, or to any employee of a controlled commercial entity of a foreign government.

6. Dual resident companies (sec. 112(u) of the bill, sec. 1249 of the Reform Act, and sec. 1503 of the Code)

Present Law

The Act provides that if a U.S. corporation is subject to a foreign country's tax on worldwide income, or on a residence basis as opposed to a source basis, any net operating loss it incurs cannot reduce the taxable income of any other member of a U.S. affiliated group for that or any other taxable year. A net operating loss of such a company is referred to as a "dual consolidated loss." Regulatory authority is provided to exclude a loss from the ambit of this rule to the extent that that loss does not offset the income of foreign corporations for foreign tax purposes.

Explanation of Provision

The bill provides that, to the extent provided in regulations, any loss of any separate and clearly identifiable unit of a trade or business of the taxpayer is to be treated as a dual consolidated loss as if that unit were a wholly owned subsidiary of that corporation. For example, assume that a U.S. corporation maintains a branch in a foreign country. That foreign country allows the loss of that branch to offset the taxable income of a locally incorporated corporation that is wholly owned by the U.S. corporation (or an affiliate of the U.S. corporation). The branch incurs, for both U.S. and foreign tax purposes, a net operating loss of $100. The foreign corporation earns income of $100. The U.S. corporation, viewed as a whole, has neither gain nor loss for the year: the $100 loss of the branch offsets $100 of income generated by the rest of the U.S. corporation. Under the bill, regulations may provide that the branch's $100 loss is treated as a dual consolidated loss. It is anticipated that regulations will so provide to the extent that the branch's loss offsets the income of a foreign corporation for foreign purposes. In that case, that loss may not be used to offset the income that the U.S. corporation earns other than from the branch operation. Thus, the taxable income of the U.S. corporation is $100. The branch's $100 loss is available for carryforward against future income of the branch.

The bill also provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the dual consolidated loss provision by a contribution of assets to the corporation with the dual consolidated loss after the corporation sustained it. This provision is designed to protect the integrity of the Act's rule that prevents the income generated by assets of one related corporation from being offset by losses incurred with respect to assets of another related corporation, the losses of which were also within another country's tax jurisdiction. Under the Act, a U.S. corporation with a dual consolidated loss can use that loss to offset income generated by its assets only, and cannot use that loss to offset income generated by assets of affiliates. This provision of the bill should prevent an affiliate from transferring assets the income of which could not be sheltered under the Act to the company that has the dual consolidated loss in an attempt to shelter those assets' income. On the other hand, the provision is not designed to prevent the replacement of existing assets, for example, in the case of a corporation operating a trade or business that replaces its assets because of depreciation.

F. Foreign Currency Exchange Rate Gains and Losses (sec. 112(v) of the bill, sec. 1261 of the Reform Act, and secs. 986-989 of the Code)

1. Foreign currency translation

Present Law

Translation of foreign income taxes

Subpart J of the Code, as added by the Act, provides rules for the translation of foreign income taxes that enter into various computations involving the foreign tax credit. Foreign income taxes are defined for purposes of subpart J as any income, war profits, or excess profits taxes paid to any foreign country or any possession of the United States. For foreign tax credit and foreign tax deduction purposes, income, war profits, and excess profits taxes include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

Generally for purposes of computing either the direct or indirect foreign tax credit, the amount of foreign income taxes paid to a foreign government or U.S. possession is translated, under subpart J, using the exchange rate in effect as of the time of payment; any refund or credit of a foreign income tax is translated using the exchange rate in effect as of the time of the original payment; and any increase in the amount of a foreign income tax is intended to be translated using the exchange rate in effect when the increase is paid. (Congress did not intend the payment date rule to prevent the allowance of a credit based on accrued foreign taxes where those taxes are unpaid when the credit must be computed.)

Translation of section 956 income inclusions

On the actual distribution of earnings and profits from a foreign corporation to a U.S. taxpayer, the latter is required to translate such amounts (if necessary) at the current exchange rate on the date the distribution is included in income. In the case of deemed distributions under section 951(a) of subpart F, the required income inclusion is first calculated in the functional currency and then translated at the weighted average exchange rate for the foreign corporation's taxable year. The Secretary may adjust these translation rates by regulation.

Where earnings of a controlled foreign corporation are repatriated, the Code generally aims at achieving similar tax results whether the repatriation is in the form of a dividend or of an increase in investment in U.S. property (*see* secs. 951(a)(1)(B) and 956). However, the translation rules described above provide for computing translation rates differently depending on the form of repatriation. Congress did not intend to provide taxpayers their choice of tax results based on translation method where a similar economic result is achieved in either case.

Explanation of Provisions

Translation of foreign income taxes

The bill clarifies that in applying the foreign income tax translation rules of new subpart J (as well as the other foreign provisions of the Code), foreign taxes imposed in lieu of income taxes are treated the same as foreign income taxes.

The bill also clarifies that the exchange rate to be used for determining the dollar cost of any payment of foreign income tax (including a payment constituting an adjustment to a payment of foreign tax) is the exchange rate as of the time the taxes are paid to the foreign country or U.S. possession. The bill applies this rule whether the entity paying the tax to the foreign government or U.S. possession is the taxpayer or (as in the case where the taxpayer claims an indirect foreign tax credit) a corporation of which the taxpayer is a shareholder, and whether or not the tax is paid by a qualified business unit.

Translation of section 956 income inclusions

The bill provides that subpart F inclusions under section 951(a)(1)(B), relating to increases in investments in U.S. property, are to be translated at the same rates as actual distributions made on the last day of the taxable year, i.e., using the spot rate on that day. This reduces the opportunity for taxpayers to manipulate tax liability based on the foreseeable difference between the weighted average annual rate and the spot rate as of the date when earnings repatriation is to occur. The Secretary retains authority to further adjust translation rates, under regulations, where regulatory adjustments can usefully promote the aim of achieving similar translation results regardless of whether the repatriation takes the form of dividends or investments in U.S. property.

2. Foreign currency transactions

Present Law

Exclusion from section 988 treatment for section 1256 contracts

Section 988(c) defines the term "section 988 transaction" to include, among other things, (1) the acquisition of (or becoming the obligor under) a debt instrument, (2) the disposition of nonfunctional currency, and (3) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (such as a currency swap), if such instrument is not marked to market at the close of the taxable year under section 1256. Congress did not intend to change generally the treatment of bank forward contracts, regulated futures contracts, or other contracts subject to the mark-to-market rule under section 1256. Therefore, Congress intended to exclude such instruments from the definition of a section 988 transaction.

Measurement and recognition of foreign currency gain or loss

Section 988(b) defines foreign currency gain or loss as gain or loss on a section 988 transaction, but only to the extent the gain or loss is realized by reason of a change in exchange rates between the booking date with respect to that transaction and the payment date of the transaction. In the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency.

For transactions involving forward contracts or similar positions, the booking date is the date on which the position is entered into or acquired; the payment date includes the date on which a taxpayer's rights are terminated with respect to the position (e.g., by entering into an offsetting position). The definition of foreign currency gain or loss is intended to apply to gain or loss attributable to exchange rate movements between those dates affecting the value of forward contracts or similar instruments, regardless of the particular transaction in which the gain or loss is realized.

The Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, where a debt instrument, the acquisition of which is a section 988 transaction, is converted to stock, the sale of which is not a section 988 transaction, the Act gives the Secretary the authority to prevent any foreign currency gain inherent in the debt instrument from escaping subpart J treatment.

Section 988 hedging transactions

The Act authorizes the issuance of regulations that address the treatment of transactions that are part of a section 988 hedging transaction. To the extent provided in regulations, in the case of any transaction giving rise to foreign currency gain or loss that is part of a section 988 hedging transaction (determined without regard to whether any position in the hedge would be marked to market under section 1256), all positions in the hedging transaction are integrated and treated as a single transaction, or otherwise treated consistently (e.g., for purposes of characterizing the nature of income or the sourcing rules). In the case of a foreign currency borrowing fully hedged with a series of forward purchase contracts, for example, Congress intended that regulations treat the entire package as a dollar borrowing with dollar interest payments subject to the rules of section 1271 et seq. and section 163(e) for determining the appropriate interest deduction.

Sourcing rules

In general, foreign currency gain is sourced, and foreign currency losses are allocated, by reference to the residence of the taxpayer or qualified business unit on whose books the underlying financial asset or liability is properly reflected. For purposes of these rules, an individual's residence is defined as the country in which the "tax home" (as defined in sec. 911(d)(3)) is located. The residence of any U.S. person (as defined in sec. 7701(a)(30)) other than an individual is the United States. In the case of a foreign corporation, partnership, trust, or estate, the residence is treated as a foreign country.

The Secretary has authority to prescribe regulations carrying out the purposes of the Act's currency sourcing provisions as well as regulatory authority under the rules introduced by the Act for determining generally the source of income derived from the sale of personal property. Under the latter it was contemplated that regulations may be required to prevent persons from establishing partnerships or corporations, for example, to change their residence to take advantage of the new rules. It was anticipated that the establishment of an anti-abuse rule to treat, for example, a foreign partnership as a U.S. resident to the extent its partners are U.S. persons would be appropriate.

Explanation of Provisions

Exclusion from section 988 treatment for section 1256 contracts

The bill provides that if a forward contract, futures contract, option, or similar financial instrument would have been marked to market under section 1256 were it held on the last day of the taxable year, then the instrument is not a "section 988 transaction" even if it is not actually marked to market under section 1256 *at the close of the taxable year*. This amendment clarifies that taxpayers who acquire 1256 contracts cannot elect 988 rules for characterizing, timing, and sourcing or allocating the income or loss on such contracts simply by disposing of the contracts prior to the last day of the taxable year.

Measurement and recognition of foreign currency gain or loss

The bill provides that any gain or loss from a section 988 transaction is a foreign currency gain or loss if the transaction is a disposition of nonfunctional currency or a forward contract, futures contract, option, or similar financial instrument with respect to a nonfunctional currency. This makes it clear that any gain or loss on such an instrument due to forward premium or forward discount is subject to the Act's rules for foreign currency gains and losses, regardless of movements in the spot rates of exchange between the booking and payment dates. Further, any gain or loss on a nonfunctional currency disposition is foreign currency gain or loss regardless of whether the difference between acquisition and disposition prices is due to spot rate movements between acquisition and disposition dates, forward discount or premium, bid-asked spreads, or other factors.

The bill provides that making or taking delivery under a section 988 transaction that is a forward contract, futures contract, option, or similar financial instrument is a gain or loss recognition event (*cf.* sec. 1256(c)). This rule prevents taxpayers from opting for alternate treatment on such a transaction by selling or otherwise closing out the position, on the one hand, or taking or making delivery, on the other. Under a transitional provision, this rule will not change the treatment of deliveries taken by a taxpayer on or before the date of the bill's introduction.

Where an option or similar instrument gives its owner the right to make or take multiple deliveries of currency at different times during the life of the instrument, it is intended that the bill's recognition rule will generally treat the taxpayer as having sold an instrument representing that portion of the rights exercised at the time a particular delivery under the instrument is made or taken. It is anticipated that the Secretary will exercise his regulatory authority under subpart J to provide rules for the allocation of any basis in the instrument for these purposes, to prevent the artificial acceleration of loss in such a case, and to impose any other requirements necessary or appropriate to carry out the purposes of the bill's recognition rule.

Section 988 hedging transactions

The bill provides that where all transactions that are part of a section 988 hedging transaction are integrated and treated as a single transaction or otherwise treated consistently under regulations, such treatment applies for purposes of all provisions in subtitle A of the Code. Thus the bill makes clear Congress's intent that Code provisions other than section 988 are to be applied to the components of a section 988 hedging transaction in their integrated or otherwise combined state (where regulations provide for such integration or combination).

Sourcing rules

For purposes of the currency sourcing rules as well as the general source rules for income derived from the sale of personal property, the bill treats any U.S. citizen or resident alien as a U.S. resident if he or she does not have a tax home in a foreign country. Thus the bill prevents such an individual from being treated as a nonresident if he or she has no tax home (which may be the case, for example, for a traveling salesperson).

The bill also clarifies that the Secretary's regulatory authority to determine the source of foreign currency gains encompasses authority to determine the source of a partnership's foreign currency gains by reference to the residence of the partners. It is anticipated that this authority will be exercised where necessary to prevent persons from establishing partnerships to change their residence to take advantage of the new rules.

G. Tax Treatment of Possessions (Sec. 112(w)-(z) of the bill, secs. 1274-1277 of the Reform Act, and secs. 931 and 932 of the Code)

Present Law

Mirroring of Virgin Islands coordination rule

The Act contains a new provision coordinating U.S. and Virgin Islands income taxes (Code sec. 932). That Code section does not apply for purposes of determining income tax liability incurred to the Virgin Islands. The intent of Congress in not having that provision apply for V.I. tax purposes was to prevent any argument that 48 U.S.C. 1397 (the provision of the Naval Appropriations Act of 1922 that holds the U.S. income tax laws, as amended, to be "likewise in force in the Virgin Islands") or the Revised Organic Act of the Virgin Islands could require "mirroring" of the new coordination provision for internal Virgin Islands purposes.

Treatment of Virgin Islands residents

The Act provides that in the case of an individual who is a bona fide resident of the Virgin Islands at the close of the taxable year and who, on his or her return of income tax to the Virgin Islands, reports income from all sources and identifies the source of each item shown on such return, for purposes of calculating income tax liability to the United States, gross income shall not include any amount included in gross income on the V.I. return. The Act indicates that such an individual is to file his income tax return with the Virgin Islands.

Effective date of prohibition of branch tax

The provisions of the Act applicable to Guam, American Samoa, and the Northern Mariana Islands generally apply only if and so long as an implementing agreement under Act section 1271 is in effect between the United States and such possession. The Act provides that for certain corporations created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands, the branch tax does not apply. This provision is to be mirrored, so that the branch tax does not apply to U.S. corporations with operations in any of those possessions.

Explanation of Provisions

Mirroring of Virgin Islands coordination rule

The bill provides that in applying Code section 932 (the provision coordinating U.S. and Virgin Islands income taxes) for purposes of determining income tax liability incurred to the Virgin Islands, the provisions of section 932 are not to be affected by any provision of Federal law described in section 934(a), i.e., the Naval Appropriations Act or the Revised Organic Act. Thus, while there is not to be "mirroring" of this provision, this provision, insofar as it determines the taxable income of Virgin Islands residents, has effect for V.I. tax purposes.

Treatment of Virgin Islands residents

The bill adds to the bona fide resident requirement and the reporting requirement a third requirement for exclusion of items reported on a V.I. return. That further requirement is that the individual seeking the exclusion fully pay his or her tax liability (referred to in sec. 934(a)) to the Virgin Islands with respect to income from all sources. In addition, the bill provides that in the case of an individual whose gross income excludes amounts included on a V.I. return, allocable deductions and credits are not to be taken into account. The bill also makes it clear that such an individual is to file "an" income tax return with the Virgin Islands, rather than filing "his" return with the Virgin Islands, to make it clear that individuals who do not comply with all requirements for U.S. tax exemption will have to file a U.S. return.

Effective date of prohibition of branch tax

The bill makes it clear that the rule prohibiting the imposition of the branch tax on certain corporations organized in the possessions (and thus the prohibition of imposition of the branch tax by a possession on a U.S. corporation) applies for taxable years beginning after December 31, 1986.

H. Miscellaneous Foreign Provisions

1. Relationship with treaties (sec. 112(aa) of the bill, Title VII and Title XII of the Reform Act, and sec. 7852 of the Code)

Present Law

In general, when a statute and a treaty provision conflict, the one adopted later controls. When Congress enacted the Internal Revenue Code of 1954, it included in that Code (sec. 7852(d)) a statement that no provision of the Internal Revenue title, *i.e.*, the Internal Revenue Code, was to apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). The intent of that provision was to provide a transitional rule to ensure that the substitution of the 1954 Code for the preexisting 1939 Code did not operate to override then-existing treaty provisions. A House bill provision amending Code section 7852(d) to reflect that intent—that post-1954 statutory changes not yield to pre-1954 treaties—was inadvertently dropped in the 1986 Tax Reform Act.

In a number of respects, the Act (and its legislative history) did not specifically address its interaction with U.S. treaties. Many recent tax Acts, by contrast, have specifically addressed interaction with treaties. "[I]n the interest of forestalling any possible litigation," the Revenue Act of 1962 expressly provided that it took precedence over any prior treaty obligation (H.R. Rep. No. 1447, 87th Cong., 2d Sess. 96 (1962); Pub. L. No. 87-834, sec. 31). One major conflict between that Act and treaties, not identified in the legislative history of that Act, was the conflict between the Act's separate foreign tax credit limitation for interest income and treaties that (at least literally) required the United States to retain the foreign tax credit limitation rules that it used at some earlier date.

The Foreign Investors Tax Act of 1966 took the opposite approach. Although that Act reduced the burdens on foreign investors and thus no treaty violations were found, the Act (sec. 110) specifically provided that it did not apply in any case where its application would be contrary to any U.S. treaty obligation. In more recent years, Congress has specifically indicated that it intended that tax Acts prevail over treaties in the case of conflicts. Congress took this approach with respect to the foreign tax credit changes in the Tax Reform Act of 1976 (H.R. Rep. No. 94-658, 94th Cong., 2d Sess. 226 (1975); S. Rep. No. 94-938, 94th Cong., 2d Sess. 237 (1976)) and with respect to the Crude Oil Windfall Profit Tax Act of 1980 (H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 106 (1980) (conference report)). In connection with the Deficit Reduction Act of 1984, Congress resolved certain conflicts in favor of treaties but indicated that, in the event of unidentified treaty conflicts, the legislation is to prevail (see description of technical corrections made to the 1984 Act by the 1986 Act, H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 917 (1985); S. Rep. No. 99-313, 99th Cong., 2d Sess. 935 (1986)).

Explanation of Provision

The bill modifies the 1954 transition rule (embodied in sec. 7852(d)) governing the relationship between treaties and the Code to clarify that it does not prevent application of the general rule providing that the later in time of a statute or a treaty controls (sec. 7852(d)). The bill provides that no provision of the Internal Revenue title that was in effect on August 16, 1954, shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). This provision makes it clear that treaty provisions that were in effect in 1954 and that conflict with the 1954 Code as originally enacted are to prevail over then-existing Code provisions but not over later amendments to the Code.

The bill clarifies the interaction between the 1986 Act and provisions of U.S. treaties. The bill provides that the following provisions of the 1986 Act will not apply to the extent that their application would be contrary to any income tax treaty obligation of the United States in effect on the date of enactment of the 1986 Act (October 22, 1986): section 123 of the Act (imposing tax on certain scholarship and fellowship grants); subsections (b) and (c) of section 1212 of the Act (imposing a 4-percent gross withholding tax on certain transportation income earned by foreign persons and amending the rules that allow a reciprocal exemption for certain transportation income earned by foreign persons); section 1247 of the Act (relating to the exemption that the United States provides to foreign governments in some cases); and section 1242 of the Act insofar as it relates to new Code section 864(c)(7) (treating gain from sale of assets used in a U.S. trade or business as effectively connected income after cessation of the trade or business in certain cases). In addition, in the event of conflict with an income tax treaty, the source rules of section 1212(a) of the Act (governing the source of certain transportation income) and of section 1214 of the Act (governing the source of payments from 80/20 companies) will not apply except for purposes of the foreign tax credit limitation. Further, the provisions of section 1241 of the Act that relate to new Code section 884(f)(1)(A) (to the extent that that provision treats interest paid in excess of interest deducted as U.S. source) and to Code section 861(a)(2)(B) (reducing the fraction of U.S. income that exposes a foreign corporation to U.S. withholding tax on dividend payments it makes) will not apply in the event of a treaty conflict. In addition, in the event of conflict with an income tax treaty, the source rules of section 1211 of the Act (determining the source of income from certain sales of personal property) will not apply to individuals treated as residents of a treaty country under a U.S treaty.

Moreover, to the extent that the source rule of Code section 865(e)(2) conflicts with a U.S. income tax treaty, the bill provides that the treaty will prevail. A conflict may arise with this source rule because, under the Act, income derived by a foreign person from the sale of inventory property that is attributable to a U.S. office is U.S. source. This result occurs even though the sale may occur outside the United States and a foreign country may tax the sale on a source basis. By contrast, a U.S. resident who sells inventory property outside the United States may not pay any U.S. tax on the income because the income is considered foreign source. Thus, the nonresident may incur more burdensome taxation than a similarly situated U.S. resident. If this occurs, the bill allows a nonresident with nondiscrimination protection to treat this income as foreign source.

Moreover, the bill provides that the Act's imposition of tax in certain cases on "excess interest" (i.e., the amount of a foreign corporation's U.S. interest deduction in excess of the amount of interest its U.S. trade or business has paid) will not apply in the event of a treaty conflict.

The bill's amendments to Act section 1211, described in Part XII. B.1., above, provide a coordination rule for cases where sales of stock and certain intangibles yield foreign source income under an income tax treaty and U.S. source income under new Code section 865.

The bill provides that the following provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986): section 1201 of the Act, amending the foreign tax credit limitation, and section 701 of the Act (as it relates to the limitation on the use of foreign tax credits against minimum tax liability).

Except for cases that have been identified in the bill or in the Act, no cases are known where a harmonious reading of the Act and U.S. treaties is not possible. Congress intended harmonious construction of the Act and U.S. income tax treaties to the extent possible. Thus, in some cases, despite the existence of technical arguments alleging the existence of a conflict, it is understood that no conflict exists. For example, it is understood that no nondiscrimination provision of any U.S. treaty bars the application of reasonable collection mechanisms designed to ensure the collection of a tax, the imposition of which is permitted by the treaty. Thus, it is understood that the Act's partnership withholding provision and the bill's replacement provision (new Code sec. 1446), which allow for refunds in appropriate cases, constitute such a reasonable collection mechanism, and thus are fully consistent with existing U.S. treaty obligations.

Similarly, it is understood that the Act's imposition of tax on installment gains received after a foreign person ceases a U.S. trade or business (Act section 1242) is fully consistent with existing U.S. treaty obligations. Some treaties prevent imposition of U.S. tax on business profits of a foreign person unless those profits are attributable to a permanent establishment through which the foreign person carries on business in the United States. It is understood that these treaties do not prevent imposition of U.S. tax on income that was, when realized, attributable to a permanent establishment, even though that income is recognized after the permanent establishment no longer exists. Under a similar analysis, it is understood that the Act creates no conflict with treaties in taxing amounts earned for personal services in the United States which are paid after the person earning the income no longer maintains a U.S. presence.

Other Act provisions that are understood to be fully consistent with U.S. treaty obligations include the Act's dual residence company provisions (Act sec. 1249).

Similarly, requiring recognition of gain by a domestic corporation that is liquidating into a foreign parent corporation or engaging in a tax-free reorganization where the domestic corporation's assets are being removed from U.S. taxing jurisdiction does not violate any nondiscrimination clause. In some cases, provisions based on capital ownership prohibit imposition of more burdensome taxes on foreign-owned U.S. enterprises than on similar U.S.-owned U.S. enterprises. For this purpose, however, a U.S. enterprise transferring assets to a shareholder who will bear U.S. corporate level tax on the income generated by those assets is not similar to a U.S. enterprise transferring assets to a shareholder who will not bear U.S. corporate level tax on the income generated by those assets. Thus, the Act's provision recognizing gain in these cases (sec. 631(d)), and the bill's provision making modifications thereto, are fully consistent with U.S. treaty obligations. Nonetheless, in view of an Internal Revenue Service announcement (subsequently withdrawn) indicating that certain liquidations were treaty-protected, it is intended that the Reform Act's amendments to Code section 367(e)(2) not apply in the case of a corporation completely liquidated into a treaty-country parent before June 10, 1987, the date of the bill's original introduction.

If, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty.

Notwithstanding Congress' intent that the Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found or alleged to exist. Therefore, to prevent any uncertainty and to prevent assertion of treaty claims whose merit is not now known, the bill provides that except as otherwise provided by the bill or the Act, the provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986). It is believed that this residual later-in-time rule will lead to the early discovery of now-unknown treaty conflicts and to their appropriate resolution. If any such now-unknown conflict is ultimately found, it is expected that full legislative consideration of that conflict will take place to determine whether application of the general later-in-time rule is consistent with the spirit of the treaty (namely, to prevent double taxation by an agreed division of taxing jurisdiction, and to prevent fiscal evasion) and the proper expectations of the treaty partners.

If further conflicts requiring reversal of the later-in-time rule are found after enactment of this bill, retroactive liberalization will be appropriate. *See, e.g.*, section 112(bb)(4) of this bill, reversing retroactively and application of the residual later-in-time rule applicable to the Deficit Reduction Act of 1984. Retroactive increases in tax burdens, by contrast, raise Constitutional issues. *See, e.g., United States v. Darusmont*, 449 U.S. 292 (1981).

It is noted that this residual later-in-time rule was a part of the introduced technical corrections bill in each House of Congress (H.R. 2636, S. 1350), and that during the legislative process considering this bill, a number of previously unknown treaty conflicts became known. It is believed that the residual later-in-time rule of the introduced bill may have encouraged taxpayers to raise potential conflicts that might have violated the spirit of U.S. treaty obligations. In any event, in each case where a conflict became known after original introduction of the bill, the bill provides that the treaty is to prevail. It is believed that, in view of this incentive to bring meritorious cases to light, the residual later-in-time rule may have allowed the identification of virtually all cases where there would have been an application of that rule that violates the spirit of a treaty, so that the residual later-in-time rule actually conflicts with treaties in very few if any inappropriate cases. It is believed that retention of the residual later-in-time rule will prevent assertion of hypertechnical treaty claims that have no basis in the spirit of the treaty.

In addition, except as indicated in this bill, the 1987 Budget Reconciliation Act or its legislative history, or in other portions of the legislative history of this bill, this bill and the 1987 Budget Reconciliation Act are understood not to conflict with any treaty. Again, should a conflict ultimately appear, the bill's and the Act's provisions are to take effect.

2. Foreign personal holding companies (sec. 112(bb)(1) of the bill, sec. 1810(h) of the Reform Act, and secs. 551 and 552 of the Code)

Present Law

Estates and trusts owning shares of foreign personal holding companies

United States shareholders in a foreign personal holding company (FPHC) are subject to current U.S. tax on their pro rata share of the company's undistributed FPHC income. The FPHC rules were enacted in 1937 to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks."

In 1937 there was no statutory definition distinguishing estates and trusts that were U.S. taxpayers (for revenue act purposes in general) from those that were not. For purposes of the FPHC rules, an estate or trust was considered a "U.S. shareholder" in an FPHC unless gross income of the estate or trust for federal income tax purposes included only income from U.S. sources. Subsequently, the Code was amended to include generally applicable definitions of the terms "foreign estate" and "foreign trust." (Under current law, these terms mean an estate or trust, as the case may be, the income of which, from sources outside the United States which is not effectively connected with a U.S. trade or business, is not includible in gross income under the Code's income tax provisions (sec. 7701(a)(31)).)

The foreign personal holding company rules contain a tracing rule, added by the Tax Reform Act of 1984, to make it clear that U.S. taxpayers cannot avoid the FPHC rules by interposing foreign entities between themselves and a FPHC. The 1984 Act grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the FPHC rules as may be necessary to carry out the purposes of this tracing rule. The 1986 Act included a technical amendment to the tracing rule to clarify that the tracing rule applies to all foreign trusts and estates (as defined for Code purposes generally) interposed between U.S. taxpayers and FPHCs.

Same country dividend and interest exception

The 1984 Act provided that dividends and interest received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country, generally do not count in either the numerator or the denominator of the fraction that is used in determining whether the foreign corporation is an FPHC. The 1986 Act provided a definition of related person for this purpose.

Explanation of Provisions

Estates and trusts owning shares of foreign personal holding companies

Under the bill, estates and trusts that are shareholders in an FPHC are U.S. shareholders for purposes of the FPHC rules unless they are foreign estates or trusts under the general Code definitions of those terms. The bill clarifies that the 1986 Act's amendment to the FPHC tracing rules treats estates and trusts as intervening foreign entities if and only if they are foreign estates and foreign trusts under the general Code definitions.

The bill provides that, in making adjustments to the tracing rules by regulation, the Secretary may impose rules similar to the rules of Code section 1297(b)(5) (as amended by the bill) applicable to passive foreign investment companies (PFICs). These rules will provide for similar treatment, under regulations, of distributions from FPHCs, on the one hand, and entities through which FPHC ownership is attributed, on the other. For example, where stock ownership in a FPHC is attributed to a U.S. person through an intervening entity, it is anticipated that regulations will treat distributions received by the intervening entity as being received by the U.S. person. These regulations will prevent reduction of FPHC income by virtue of distributions that result in no U.S. tax.

Same country dividend and interest exception

The bill makes amendments to the 1984 and 1986 Act provisions relating to the same country dividend and interest exception to FPHC income treatment. One such amendment defines a new term, "related person dividend or interest," as a same country dividend or same country interest of the type excluded from FPHC income under the 1984 Act. The bill restores related person dividend and related person interest to the denominator of the fraction used in determining whether a foreign corporation is an FPHC. The bill also restores FPHC income treatment of a related person dividend or interest if the dividend or interest is attributable to income of the related person which would be FPHC income.

Thus, for example, where the entire amount of a foreign corporation's income is related person dividends and related person interest, and in any taxable year some of that income, but less than 60 percent (assuming the corporation has never been an FPHC), is attributable to income of the related person which would be FPHC income, the bill prevents the foreign corporation from being treated as an FPHC.

Attribution of dividends and interest to income of the related person is to be determined under rules similar to the foreign tax credit look-through provisions for dividends and interest paid to a U.S. shareholder by a controlled foreign corporation. Under these rules, a dividend paid out of the earnings and profits of a corporation is to be treated by the recipient as FPHC income in proportion to the FPHC earnings and profits out of which the dividend was paid, divided by the total earnings and profits out of which the dividend was paid (*cf.* sec. 904(d)(3)(D)). Similarly, interest received or accrued from a corporation is to be treated as FPHC income to the extent properly allocable (under regulations prescribed by the Secretary) to FPHC income of the corporation (*cf.* sec. 904(d)(3)(C)).

All of the bill's provisions described above regarding foreign personal holding companies apply to taxable years of foreign corporations beginning after December 31, 1986.

3. Withholding on pensions, annuities and certain other deferred income (sec. 112(bb)(2) of the bill, sec. 1234(b) of the Reform Act, and sec. 3405 of the Code)

Present Law

The Act provides that pension benefits (and similar payments) are subject to withholding under section 3405 if delivered outside the United States. The election generally available to U.S. persons to forego withholding under section 3405 is not available in such cases. Congress enacted this provision with a view to taxing persons who reside abroad yet are likely to owe U.S. income tax on pension benefits (and similar payments) that they receive.

Explanation of Provision

The bill clarifies that the Act's automatic withholding rule does not apply if the recipient certifies to the payor that he or she is not a U.S. citizen or a resident alien of the United States, and not a tax avoidance expatriate. Thus under the bill the automatic withholding rule generally applies to foreign-delivered pension benefits and similar payments to individuals subject to U.S. income taxation on their worldwide income.

In addition, the bill restricts automatic withholding under the Act to those benefits and payments that are delivered outside both the United States and its possessions. Thus, recipients of benefits and payments delivered in any U.S. possession would continue to be eligible to elect to forego withholding on the same terms available to taxpayers whose payments or benefits are delivered in the United States. These amendments would apply to distributions made after the date of the bill's enactment.

4. Information exchange (sec. 112(bb)(3) of the bill, sec. 1876(e) of the Reform Act, and sec. 6103 of the Code)

Present Law

Tax returns and return information generally may not be disclosed by government employees except as specifically provided in the Code. Violation of the nondisclosure rules may result in sanctions, including criminal felony conviction in the case of a willful violation. One Code exception to the general nondisclosure rule permits disclosure of a return or return information to a competent authority of a foreign government which has an income tax convention, gift and estate tax convention, or other convention relating to the exchange of tax information with the United States, but only to the extent provided in, and subject to the terms and conditions of, the convention. The Code also permits disclosure of a return or return information to state government agencies under certain circumstances. For these purposes the term "state" is defined to include the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau.

In 1983, the Caribbean Basin Economic Recovery Act authorized the Secretary of the Treasury to negotiate and conclude bilateral and multilateral agreements for the exchange of information with designated "beneficiary countries" under the Caribbean Basin Initiative (CBI). Congress expected that these agreements would generally become effective on signature, without need of prior approval by the Senate. The Code treats these agreements with CBI beneficiary countries as income tax conventions for return and return information disclosure purposes.

The Compact of Free Association Act of 1985 gave approvals to compacts subsequently entered between the United States and the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau that provide for their self-government. Congress provided that under those compacts the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau would be treated as if they were U.S. possessions for purposes of the possessions tax credit (Code sec. 936), but that this treatment would not apply for any period after 1986 in which there is not in effect an exchange of information agreement of the kind described in the Caribbean Basin Economic Recovery Act. The Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau are not CBI beneficiary countries.

The 1986 Act provided that a country may qualify as a host country for foreign sales corporations (FSCs) by entering into an exchange of information agreement of the type provided for in the Caribbean Basin Economic Recovery Act, whether or not that country is eligible to be a CBI beneficiary country.

Explanation of Provision

The bill clarifies that tax returns and return information may be disclosed to a competent authority of a foreign government where the disclosure is made pursuant to a bilateral agreement relating to the exchange of tax information with the United States. Thus, where a country other than a CBI beneficiary country enters into a bilateral information exchange agreement of the type that qualifies it as a FSC host country under the Act, for example, or that qualifies it for the possessions tax credit pursuant to the Compact of Free Association Act, the bill provides express protection to individuals who make disclosures in accordance with the terms of the agreement from Code sanctions for unauthorized disclosures. By contrast, however, the bill does not contemplate the release of information under multilateral agreements involving non-CBI countries.

In addition, the bill provides that the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau are not to be treated as "states" for purposes of the disclosure provisions of the Code. Thus, an authorized disclosure under a bilateral information exchange agreement between the United States and one of those governments will be subject only to the rules embodied in that agreement and the usual rules for information exchanges with foreign governments, and will not be subject to any additional rules that might apply to exchanges of tax returns and return information between the federal government and state governments or certain U.S. possessions.

5. Maintaining the source of U.S. source income (sec. 112(bb)(4) of the bill, sec. 1810(a) of the Reform Act, and sec. 904(g) of the Code)

Present Law

Prior to the 1984 Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporation: interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The 1984 Act added to the foreign tax credit new "resourcing" rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. They treat certain payments from, and income inclusions (*e.g.*, under the subpart F anti-tax haven provisions) arising on account of, 50-percent U.S.-owned foreign corporations, as U.S. source.

The 1986 Act made it clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation.

Explanation of Provision

The bill provides new treatment for any amount derived from a 50-percent U.S.-owned foreign corporation that the statute would treat as U.S. source income (because it is attributable to an item of U.S. source income earned by that foreign corporation), that a treaty (applied without regard to the statutory source maintenance provision) would treat as foreign source, and with respect to which the taxpayer chooses the new treatment. Upon such a taxpayer election, to the extent attributable to an item of U.S. source income earned by that foreign corporation, the taxpayer's inclusion is treated as foreign source income that is subject to a separate foreign tax credit limitation. The bill extends this elective treatment to subpart F inclusions (Code section 951(a)((1)) by treating any such inclusion as if it were a dividend from the controlled foreign corporation causing the inclusion but only if a dividend from each intermediary corporation in the layers of ownership between the corporation generating the subpart F inclusion and the U.S. shareholder would be treaty protected if paid to the U.S. shareholder. It is anticipated, however, that for administrative convenience the Secretary may allow grouping of similar items that are similarly taxed by a foreign country in applying the separate foreign tax credit limitation.

6. Stock sales treated as asset sales (sec. 112(bb)(5) of the bill and sec. 338 of the Code)

Present Law

In the case of purchase of a controlling interest in the stock of a target corporation, section 338 allows the purchasing corporation, in certain circumstances, to make an election under which the target corporation is deemed to sell its assets to itself at fair market value at the close of the acquisition date. If prior to the transaction the target joined in filing a consolidated return, regulations under section 338(h)(10) allow for an election to treat the sale of the target's stock as a sale of assets by the target, the income or loss from which is included in the consolidated return. Moreover, if an election under section 338 is made, a corporation controlled by the corporation whose stock was purchased may itself be deemed to have sold its assets.

A sale of stock in a U.S. corporation is sourced under the residence-of-the-seller rule. By contrast, a sale of stock in a foreign corporation, or a sale of assets other than corporate stock, is sourced under the residence-of-the-seller rule, the place-of-sale rule, the rules relating to intangible property, the recapture rule, or the dividend rules, depending on the type of asset sold, the income generated therefrom and, in the case of stock in a foreign corporation, the earnings of the corporation. Thus, if an election under section 338 is made, the income of the seller or the selling consolidated group inherent in the appreciation of the stock may or may not be sourced under the residence-of-the-seller rule. This may result in income being treated as foreign source even though no foreign country asserts any jurisdiction over the income, a result contrary to the Act's source and foreign tax credit rule changes.

Explanation of Provision

Under the bill, a deemed asset sale under section 338 shall generally be disregarded for source and foreign tax credit limitation purposes in determining the seller's foreign tax credit limitation, except as provided in regulations. Instead, for these purposes, the gain is generally treated as a gain from the sale of the stock. An exception to this rule is provided for gain derived from the deemed sale by a U.S. corporation of stock in a controlled foreign corporation, to the extent that the gain is treated as dividend income under section 1248 (before any deemed sale by the controlled foreign corportion of *its* assets). To that extent, income derived from the sale of stock of the U.S. corporation is treated, for foreign tax credit purposes, as income from the sale of the U.S. corporation's assets.

For example, assume a U.S. corporation holds all the stock in a controlled foreign corporation and has a basis in that stock of $0; assume the fair market value of that stock is $180. Further assume that the accumulated earnings and profits of the controlled foreign corporation through the end of its taxable year are $100, the corporation's assets have bases of $100, and its assets have appreciated in value by $80. The purchaser acquires all the stock from the U.S. corporation for $180 on the last day of the controlled foreign corporation's taxable year, and elects to treat the controlled foreign corporation as if it sold all of its assets at the close of that day for $180. The bill provides that, for source and foreign tax credit limitation purposes, the $180 of the U.S. corporation's gain is divided up as follows: $100 of gain is treated as dividend income under section 1248 and is subject to look-through treatment for foreign tax credit purposes; and $80 of gain, although treated as ordinary dividend income under Temporary Regulation section 1.338-5T(g) (which would ordinarily give rise to income subject to look-through treatment), is treated as stock gain for source and foreign tax credit limitation purposes. Under this rule then, the $80 of gain will be treated as foreign source, passive income for foreign tax credit limitation purposes (assuming the stock affiliate rule of sec. 865(f) is satisfied).

By contrast, if assets directly held by a domestic target corporation include stock in a controlled foreign corporation, and the domestic corporation is deemed under section 338 to have sold the stock, then recapture income of the domestic corporation under section 1248 on that deemed sale will be treated as 1248 recapture income from an actual sale for source and foreign tax credit purposes. However, as in the example above, the amount of such recapture income that is treated as a dividend for source and foreign tax credit purposes will be the amount of the deemed 1248 dividend determined *before* any deemed sale of the controlled foreign corporation's assets.

To the extent that any regulations prescribed under section 336(e) extend the principles of section 338 to a sale of stock in a foreign corporation, it is anticipated that those regulations will not affect inappropriately the determination of source and of a taxpayer's foreign tax credit limitation. For example, it is not appropriate to allow the conversion of foreign source passive income into overall limitation income on the sale of stock of a controlled foreign corporation by means of an election under section 338. It is intended that regulations ensure that the objectives of the Act's foreign tax credit limitation changes are preserved.

The bill's modification to section 338 is generally effective for qualified stock purchases that occur after the date of the bill's introduction. As it applies to elections under section 338(h)(10), however, the bill is effective for qualified stock purchases that occur after June 10, 1987.

7. Tax-exempt shareholders of DISCs (sec. 112(bb)(6) of the bill and sec. 995 of the Code)

Present Law

A Domestic International Sales Corporation (DISC) is deemed to distribute a certain portion of its income currently to its shareholders. Distributions of previously untaxed income of a DISC and certain amounts realized on disposition of DISC shares are taxable as dividends. A DISC is not liable for U.S. tax.

Explanation of Provision

The bill provides generally that when a tax-exempt entity (such as a qualified pension plan described in sec. 401(a) and exempt from tax under sec. 501(a)) that is a shareholder of a DISC is deemed to receive a distribution from a DISC, actually receives a distribution from a DISC of previously untaxed income, or realizes gain from disposition of DISC shares which is treated as a dividend, then that income is treated as derived from the conduct of an unrelated trade or business. This treatment prevents taxable entities from seeking to exempt active business income from tax by assigning it to their pension or profit-sharing plans. No expenses are allowable as deductions against this unrelated business taxable income. This provision is effective for taxable years beginning after December 31, 1987.

8. Treatment of certain amounts previously taxed under section 1248 (sec. 112(bb)(7) of the bill and sec. 959 of the Code)

Present Law

A U.S. shareholder that sells stock in a controlled foreign corporation must include in income as a dividend its share of the corporation's earnings and profits accumulated since the corporation was controlled and that are attributable to the stock sold (sec. 1248). Except as provided as regulations, a sale of stock in a U.S. corporation that is formed principally to hold the stock of a controlled foreign corporation is treated as a sale of the stock in the controlled foreign corporation (sec. 1248(e)), thus requiring the seller to recognize dividend income rather than capital gain.

Under the Tax Reform Act of 1984, a U.S. shareholder that purchases stock from a U.S. shareholder in a controlled foreign corporation is allowed to treat distributions received from the corporation as previously taxed income to the extent of the dividend income recognized by the seller (sec. 959(e)). Under this rule, a U.S. shareholder that purchases stock in a U.S. corporation that is formed principally to hold the stock of a controlled foreign corporation is entitled to the previously taxed income treatment, even though the U.S. corporation whose stock is sold is the actual shareholder in the controlled foreign corporation.

Explanation of Provision

The bill provides that a purchaser of stock in a U.S. corporation that is formed principally to hold the stock of a controlled foreign corporation will not receive previously taxed income treatment, but that treatment will be accorded to the U.S. corporation whose stock was acquired where dividend treatment applies to the seller of stock in the U.S. corporation under section 1248(e). Thus, the U.S. corporation can receive distributions from the controlled foreign corporation and treat them as previously taxed income to the extent of the dividend income recognized by the seller of stock in the U.S. corporation.

The bill's amendment is effective for transactions to which section 1248(e) applies and that occur after December 31, 1986.

9. Shared Foreign Sales Corporation (FSC) (sec. 112(bb)(8) of the bill and secs. 922, 924, 927 of the Code)

Present Law

A foreign sales corporation (FSC) may have up to 25 shareholders, but may not have any preferred stock.

Explanation of Provision

In general, each separate account maintained by a "shared FSC" is treated as a separate corporation for income tax purposes. A shared FSC is any foreign sales corporation that maintains a separate account for transactions with each shareholder (and persons related to such shareholder) that bases its distributions to each shareholder on the amounts in the separate account maintained with respect to each shareholder, and meets such other requirements as the Secretary may prescribe. The treatment of each separate account of a shared FSC as a separate corporation does not apply, however, for certain corporate-level requirements for FSC status, for the foreign presence requirements, for the determination whether a FSC is a small FSC, and for such other purposes as the Secretary may prescribe. This provision is effective as if included in the Deficit Reduction Act of 1984.

XIII. TAX-EXEMPT BOND PROVISIONS

(Sec. 113 of the bill, secs. 1301, 1302, and 1311-1318 of the Reform Act, and secs. 25, 103, and 141-150 of the Code)

1. Qualified small-issue bonds

Present Law

Allowance of post-sunset date refundings

Qualified small-issue bonds may be issued to finance manufacturing facilities through December 31, 1989. Authority to issue qualified small-issue bonds for nonmanufacturing facilities expired after December 31, 1986.

The Reform Act allows qualified small-issue bonds issued after August 15, 1986, to be refunded after the applicable sunset date of authority to issue the type of bond involved, if—

(a) the refunding bond has a maturity date not later than that of the refunded bond;

(b) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond;

(c) the interest rate on the refunding bond is lower than the interest rate on the refunded bond; and

(d) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of issuance of the refunding bond.

No comparable provision was contained in the 1954 Code which governs such refundings of bonds originally issued before August 16, 1986. (*See*, Reform Act sec. 1313(a).)

$40-million-per-beneficiary limit

Interest on small-issue bonds is not tax-exempt if the aggregate face amount of exempt-facility and qualified small-issue bonds (including equivalent prior-law IDBs) allocated to any beneficiary of the small-issue bonds exceeds $40 million. An exception to this rule is provided for certain current refundings of qualified small-issue bonds, under the same conditions as apply to post-sunset date refundings of such bonds (as described above).[1]

Explanation of Provisions

Allowance of post-sunset date refundings

The bill clarifies that post-sunset date current refundings (including a series of such refundings) of qualified small-issue bonds (including small-issue IDBs), which bonds are originally issued before the applicable sunset date for the type of small-issue bond involved, qualify for tax-exemption, without regard to whether the refunded (original) bonds were issued before August 16, 1986, and without regard to the requirement included in the Reform Act that the interest rate on the refunding bonds be lower than the rate on refunded bonds. Such refundings of bonds originally issued after August 15, 1986, are permitted under sec. 144(a)(12) of the 1986 Code, as modified by the bill. Refundings of bonds originally issued before August 16, 1986, are permitted under a parallel rule which is added by the bill to the 1954 Code. Under this latter rule, bonds may qualify to be refunded if they could have been originally issued on August 15, 1986 (e.g., the "substantially all" (90 percent) requirement of the 1954 Code applies rather than the new 95 percent use requirement).

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[1] In the case of refundings of bonds originally issued before August 16, 1986, the 90-day limit on completing a refunding is reduced to 30 days. *See*, Title XVIII of the Reform Act.

Post-sunset date refundings of qualified small-issue bonds are permitted under the bill provided that—

(a) the average maturity date of the issue of which the refunding bond is a part does not exceed the average maturity date of the bonds being refunded by such issue,[2]

(b) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and

(c) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of issuance of the refunding bond.[3]

As indicated above, the bill replaces the limitation on the maturity of each refunding bond, contained in the Reform Act, with a limitation on the average maturity of the refunding issue (as compared to the average maturity of the refunded bonds). However, the bill provides that any refunding bond issued before July 1, 1987, which complied with the requirement as contained in the Reform Act, is treated as satisfying the new requirement.

The bill also extends the 1954 Code sunset date for small-issue IDBs for manufacturing facilities, from December 31, 1988, to December 31, 1989. This change permits bonds for manufacturing facilities which were issued before August 16, 1986 to be refunded through December 31, 1989, without regard to the special limitations (described above) that apply to post-sunset date refundings.

$40-million-per-beneficiary limit

In conjunction with the amendments described above, the bill makes conforming changes to the refunding exception from the $40-million-per-beneficiary limit on qualified small-issue bonds. Thus, for purposes of this exception also, the weighted average maturity of the refunding bonds is compared to that of the refunded bonds, and the requirement that the refunding bonds have a lower interest rate than the rate on the refunded bonds is deleted. The bill further clarifies that a series of refundings may qualify under this exception. As under the rules for post-sunset date refundings, refunding bonds issued before July 1, 1987, which complied with the maturity requirement as contained in the Act, are treated as meeting the new requirement.

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[2] Average maturities, for this purpose, are determined in the same manner as for purposes of the limitation on private activity bond maturity to 120 percent of the economic life of the property being financed.

[3] The bill increases this period from 30 days to 90 days for refundings of bonds originally issued under the 1954 Code to conform the rules for all post-sunset date refundings of small-issue bonds.

2. Student loan bonds

Present Law

Tax-exemption is authorized for interest on qualified student loan bonds, including bonds issued in connection with the Federal GSL and PLUS programs and certain State supplemental student loan programs. Bonds issued in connection with the Federal GSL and PLUS programs must be used to finance loans that are both (1) guaranteed by the Department of Education and (2) eligible for student assistance (SAP) payments (unless such payments are precluded solely by virtue of the tax-exempt status of the bonds). Additionally, the interest charged to student borrowers must be restricted as provided in the Higher Education Act of 1965. Bonds that meet some, but not all, of these requirements (e.g., bonds the proceeds of which are used to make student loans that receive Federal guarantees, but for which SAP payments are not available) may in certain cases not meet the definition of State supplemental student loan bonds and therefore may not qualify for tax exemption.

Explanation of Provisions

The bill clarifies that student loan bonds that fail to satisfy some but not all of the requirements of Title IV of the Higher Education Act of 1985 may be issued under the exception for State supplemental student loan bonds, provided that the bonds otherwise satisfy all requirements applicable to tax-exempt supplemental student loan bonds.

The bill clarifies that an issue may not qualify as an issue of qualified student loan bonds if the issue satisfies the trade or business use and security interest tests contained in the Reform Act (Code secs. 141(b)(1) and (2)). For purposes of this provision, "use" by a section 501(c)(3) educational institution solely by reason of its administration of a student loan program does not affect the tax-exempt status of an issue, provided such use does not constitute an unrelated trade or business of the institution.

3. Qualified 501(c)(3) bonds

Present Law

Present law permits tax-exemption for interest on bonds to benefit section 501(c)(3) organizations (qualified 501(c)(3) bonds). The Reform Act provides that no more than $150 million of such bonds (other than hospital bonds) may be outstanding with respect to any section 501(c)(3) organization at any time. The tax-exempt status of bonds issued before August 16, 1986, is not affected by the provision; however, such bonds count in applying the provision to bonds issued after August 15, 1986.

In the case of pre-August 16, 1986 bonds, only the nonhospital portion of a mixed-use bond counts toward the $150-million limitation. Whether such allocations are permitted for mixed-hospital/

nonhospital-use bonds issued after August 15, 1986, is not specified in the Reform Act.

Explanation of Provisions

The bill clarifies that the proportional allocation rule included in the $150-million-per-beneficiary limit for qualified 501(c)(3) bonds, for mixed-hospital/nonhospital-use issues, applies to bonds issued after August 15, 1986, as well as to bonds issued before August 16, 1986.

The bill also adds a statutory reference clarifying that related party rules, similar to those applied for purposes of the $40-million-per-beneficiary limitation on qualified small-issue bonds, are to apply under the $150-million limitation.

4. Mortgage revenue bonds and mortgage credit certificates

Present Law

Under present law, authority to issue qualified mortgage bonds terminates after December 31, 1988. Before enactment of the Reform Act, this termination date was December 31, 1987. These bonds may not be refunded after expiration of authority to issue them.

Current refundings (including a series of refundings) of qualified mortgage bonds originally issued before August 16, 1986, remain subject to the 1954 Code. (*See*, Reform Act sec. 1313(a).) Thus, bonds originally issued before August 16, 1986, may not be refunded after December 31, 1987.

The Reform Act generally amends the provisions governing issuance of mortgage credit certificates (MCCs) to parallel the qualified mortgage bond provisions. However, the Reform Act inadvertently retained the 1987 termination date for the MCC program, rather than extending it to parallel the 1988 termination of authority to issue qualified mortgage bonds.

Explanation of Provisions

The bill extends the 1954 Code sunset date for qualified mortgage bonds from December 31, 1987, to December 31, 1988, to parallel the 1988 sunset contained in the 1986 Code. This permits qualified mortgage bonds issued before August 16, 1986, to be refunded through December 31, 1988.

Authority to elect to issue mortgage credit certificates is extended through December 31, 1988, to parallel the qualified mortgage bond expiration date.

5. Private activity bond volume limitation

Present Law

Subject to certain exceptions, State volume limitations are imposed on the issuance of (a) private activity bonds and (b) the private use portion (in excess of $15 million) of governmental issues. Bond volume authority generally may be allocated only to facilities located within the State making the allocation. Under a limited exception, volume authority may be allocated to private activity bonds for out-of-State water-furnishing, sewage and solid waste disposal, and qualified hazardous waste disposal facilities, if the issuer establishes that the State's share of the use (or output) of the facility will equal or exceed its share of the private activity bonds issued to finance the facility.

State volume authority may be carried forward for up to three years for certain specified purposes.

Explanation of Provision

The bill expands the circumstances in which State volume authority may be allocated to certain out-of-State facilities to permit such allocations for out-of-State facilities financed with governmental bonds, the private use portion of which exceeds $15 million, if the governmental facilities (a) are equivalent to any of the categories for which out-of-State allocations are permitted in the case of private activity bonds (i.e., water-furnishing facilities, sewage and solid waste facilities, and qualified hazardous waste disposal facilities), or (b) are governmental output facilities financed with tax-exempt bonds.[4]

Allocations with respect to governmental bonds are permitted only if the State's share of the use (or output) of the private use portion of the bond-financed facility equals or exceeds the State's share of volume authority allocated to the facility. Further, unlike the general rule that bond volume authority may not be allocated to an issuer that is not within or subordinate to the same State as the issuer, these allocations may, in certain cases, be made to another State. For example, assume that a governmental power generation facility is located in Nevada, but is owned by a California municipality. Assume further that the California municipality issued bonds to be advance refunded, but that the private use portion of those bonds is attributable to use by an investor-owned utility in Nevada. In such a case, Nevada may allocate its bond volume authority to the California municipality's advance refunding issue in an amount sufficient to cover the Nevada private use of the refunded (and thereby refunding) bonds.

6. Public approval requirement for private activity bonds

Present Law

In order for interest on a private activity bond to be tax-exempt, a public hearing must be held and issuance of the bonds approved by an elected public official or legislative body. (Alternatively, issuance of the bonds may be approved by a voter referendum.) Subject to certain exceptions, this requirement must be satisfied by the governmental unit issuing the bonds (or on behalf of which the bonds are issued) and all other jurisdictions in which the bond-financed property (or any part of it) is located.

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[4] Because of the limitation to $15 million per facility for private use financing for these output facilities, this provision will only apply to advance refundings of such bonds originally issued before September 1, 1986.

Explanation of Provision

The bill clarifies that, in the case of qualified scholarship funding bonds, the public approval requirement for private activity bonds is to be satisfied by a governmental unit which requested organization of the qualified scholarship funding corporation, or requested it to exercise power. In the case of such a corporation requested to act by more than one local governmental unit, the public approval requirement also may be satisfied by the State in which the corporation operates. (*See*, sec. 150(d)(2)(B).)

The bill further includes a special rule for cases where the office of the elected official responsible for approving issuance of private activity bonds is vacated (e.g., by reason of death). In such a case, a successor appointed by the chief executive officer of the State and approved by the legislative body of the State (if any) may approve issuance of bonds until a new election for the office is held with a new elected official thereafter taking office.

7. Limitation on bond-financing of issuance costs

Present Law

At least 95 percent of the proceeds of each issue of private activity bonds must be used for the exempt purpose of the issue. Amounts used to finance any costs of issuance are not treated as spent for the exempt purpose of the borrowing. Thus, these costs may be financed only from the so-called 5-percent "bad money" portion of an issue. Additionally, the amount of private activity bond proceeds that may be used to finance costs of issuance other than such costs attributable to financing of credit enhancement fees eligible for special treatment under the arbitrage restrictions is limited to two percent of the aggregate face amount of the issue. (For mortgage revenue bond issues not exceeding $20 million, this 2-percent limit is increased to 3.5 percent.)

Explanation of Provision

The bill clarifies that the 2-percent (3.5-percent) limitation on bond-financing of certain private activity bond issuance costs is applied to the proceeds, rather than the aggregate face amount, of an issue. Thus, no more than 2 percent (3.5 percent) of the proceeds of a private activity bond issue may be used to finance most issuance-related costs.

This provision is effective for bonds issued after June 30, 1987.

8. Arbitrage requirements

Present Law

General restrictions

The Reform Act continued and expanded general restrictions on the ability to invest bond proceeds at yields materially higher than the yield on the issue. In addition, the Act expanded the types of investments subject to the arbitrage restrictions from securities generally to all investment-type property.[5] The term investment property does not include tax-exempt bonds.

The Treasury Department is authorized specifically to adopt all regulations that are "necessary or appropriate to carry out the purposes" of the Code arbitrage restrictions (sec. 148(i)). Similar broad regulatory authority was granted under the 1954 Code (sec. 103(c)(7)). Treasury Department regulations and rulings issued pursuant to this regulatory authority define the term proceeds for purposes of both prior and present law and provide that certain amounts are to be treated as proceeds. These regulations restrict, *inter alia*, transactions involving sinking funds where bond proceeds are used to "replace" the amounts invested (either before or after issuance of the bonds) as part of the sinking fund. Similar treatment applies to funds that are pledged to pay debt service on an issue and, thus, are "replaced" by proceeds of the issue. *See*, e.g., Treas. reg. sec. 1.103-13(g).

In a recent case, *City of Tucson* v. *Commissioner*, 820 F. 2d 1283 (D.C. Cir., 1987), the Court of Appeals for the D.C. Circuit held Treas. Reg. sec. 1.103-13(g) to be invalid. The court further cast doubt on other provisions of Treasury regulations and the holdings of several revenue rulings issued by the Internal Revenue Service regarding replacement funds and artifices and devices. (*See*, e.g., footnotes 49, 50, 51, 52, and 54 of the court's opinion.) This case was decided under the 1954 Code, but the court indicated that the regulations also might be invalid under the 1986 Code. (On September 24, 1987, the court denied a Treasury Department petition to dismiss the case as moot because of enactment of the 1986 Code.)

General requirement to rebate arbitrage profits

Issuers of all tax-exempt bonds are required to rebate certain arbitrage profits earned on nonpurpose investments acquired with gross proceeds of the bonds.[6] The amount required to be rebated is determined, and paid, on an issue-by-issue basis. Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being due no later than 60 days after retirement of the issue.

Rebate safe-harbor for certain TRAN financings

Arbitrage profits are not required to be rebated with respect to an issue if all gross proceeds are expended for the governmental purpose of the issue within 6 months of the issue date. The Reform Act provides a special "safe harbor" for applying this exception to tax and revenue anticipation notes (TRANs). Under this safe harbor, if during the six-month period after the issue date, the cumulative cash-flow deficit of the governmental unit using the TRAN proceeds exceeds 90 percent of the aggregate face amount of the issue, all net proceeds of the TRAN issue (and any earnings thereon) are deemed to have been spent for the purpose of the issue.

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[5] In general, property is investment-type property in any case where it is held as a passive vehicle for the production of income. Thus, ownership of the physical assets of a commercial or industrial facility may, due to the purpose for which the facility is held, be investment-type property subject to yield restriction in the same manner as ownership of securities.

[6] Because tax-exempt bonds do not constitute investment property, no rebate is required when such bonds are purchased as a nonpurpose investment.

Special exception from rebate for small governmental units

The Reform Act provides a further exception to the rebate requirement for bonds issued by a governmental unit having general taxing powers, if (a) 95 percent or more of the net proceeds of the issue are to be used for local governmental activities of the issuing governmental unit (or a governmental unit entirely within the jurisdiction of the issuing governmental unit), and (b) the governmental unit reasonably expects to issue no more than $5 million of tax-exempt bonds during the calendar year in which the issuance occurs. In determining whether an issuer reasonably expects to exceed the $5-million limitation, bonds issued by the issuing governmental unit and all entities that are subordinate to it under applicable State or local law are counted. Private activity bonds are not counted toward the limit and do not qualify for this exception.

For bonds issued and refunded during the same calendar year, only the proceeds of the refunding issue are taken into account for purposes of the $5 million dollar limit. This provision does not apply to advance refundings.

The Reform Act is unclear as to the eligibility for this exception of bonds issued by subordinate units to governmental units with general taxing powers.

Exception for certain qualified student loan bonds

The Reform Act provides a limited transitional exception to the rebate requirement for qualified student loan bonds issued before January 1, 1989, in connection with the Federal GSL and PLUS programs. Under this exception, the rebate requirement does not apply to amounts earned from investing bond proceeds during an initial 18-month temporary period if—

(a) the earnings are used to pay costs of issuance financed with the bonds; or

(b) the earnings are used to pay administrative costs of the student loan program attributable to the issue and the costs of carrying the issue, but only to the extent that the proceeds of the issue are used to make or finance qualified student loans before the end of the 18-month temporary period.

This exception applies only to the extent issuers are not otherwise reimbursed for these costs.

Explanation of Provisions

General restrictions

The bill enacts into positive law the provisions of Treasury regulation sec. 1.103-13(g) regarding sinking funds. Under this provision, these regulations are to apply to all bond issues, under both the 1954 Code and the 1986 Code, in the same manner as originally provided when Treasury adopted the regulations. The bill includes this unusual provision to eliminate any ambiguity caused by the Court of Appeals decision in the *City of Tucson* case.

The bill further deletes and re-inserts the term "necessary" in the specific regulatory authority granted the Treasury Department under the arbitrage restrictions. This amendment is intended to clarify that Treasury's regulatory authority is to be interpreted broadly, rather than in a literal, dictionary manner as was done by the Court of Appeals in the *City of Tucson* case. That regulatory authority is intended to permit Treasury to eliminate any devices designed to promote issuance of bonds either partially or wholly as investment conduits in violation of the provisions adopted by Congress to control such activities and to limit the issuance of tax-exempt bonds to amounts actually required to fund the activities for which their use specifically has been approved by Congress. Further, that regulatory authority is intended to permit Treasury to adopt rules (including allocation, accounting, and replacement rules) necessary or appropriate to accomplish the purpose of the arbitrage restrictions, which is to eliminate significant arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer.

Due date of final rebate payments

The bill provides a special rule for determining the due date of the final installment of rebate payments in the case of certain short-term governmental financings. Under this rule, a series of issues that are redeemed during a 6-month period (or such longer period as the Treasury Department may prescribe) are to be treated, at the election of the issuer, as one issue, provided that no bond which is part of any issue in the series (a) has a maturity of more than 270 days or (b) is a private activity bond. Each six-month period begins on the date on which the first obligation of the series is issued, or if later, September 1, 1986.

Exception for certain TRAN financings

The bill clarifies that the expenditure determination for the "safe harbor" exception to the rebate requirement for certain tax or revenue anticipation notes (TRANs), is determined by reference to the proceeds, rather than the aggregate face amount, of an issue. Thus, under the clarification, net proceeds of an issue are treated as expended for the governmental purpose of the issue on the first day (after the date of issuance) on which the cumulative cash flow deficit to be financed by the issue exceeds 90 percent of the issue proceeds.

This provision is effective for bonds issued after June 30, 1987.

Exception for small governmental units

Aggregation of entities

Under the Reform Act, bonds of a governmental unit with general taxing powers may qualify for the special exception from arbitrage rebate only if the governmental unit and all subordinate entities reasonably expect to issue no more than $5 million of tax-exempt bonds (other than private activity bonds) during the calendar year. The bill clarifies the reference to subordinate entities contained in the Reform Act to provide that issuers are to be aggregated, for purposes of applying the $5-million limitation, as follows:

(a) An issuer, and all entities which issue bonds on behalf of that issuer, are to be treated as one issuer.

(b) If one issuer is subordinate to another entity, but does not issue bonds on behalf of the other entity, bonds issued by the subordinate entity are to be taken into account in applying the $5-million limitation to such other entity.

(c) Any entity that is formed or, as provided in Treasury regulations, availed of to avoid the purposes of the $5-million limitation, and all other entities purporting to benefit from such a device are treated as one issuer.

Treatment of refundings

The bill clarifies that current refunding bonds are not considered in determining whether an issuer otherwise qualifies for the small-issuer rebate exception provided the amount of the refunding issue does not exceed the outstanding (redeemed) principal amount of the refunded bond. Advance refunding bonds are considered in determining whether an issuer reasonably expects to issue $5 million or more in bonds in the same manner as new money bonds.

Refunding bonds (both current and advance) are themselves eligible for this exception from rebate only if (a) the refunded bond qualified for, and was taken into account under, the $5 million exception when issued,[7] (b) the aggregate face amount of the issue of which the refunding bond is a part does not exceed $5 million, (c) except in the case of refunded issues having a weighted average maturity of 3 years or less, the weighted average maturity of the refunding bonds does not exceed the weighted average maturity of the refunded bonds, and (d) no bond which is part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the original bonds).

Bonds issued by certain entities subordinate to governmental units with general taxing powers

The bill clarifies that governmental units with general taxing powers may, in certain cases, allocate to a subordinate entity part or all of the $5 million amount of governmental bonds they may issue in a calendar year. To qualify, the subordinate entity may not issue bonds in excess of the amount that could be issued if the allocating entity had directly issued the bonds. Additionally, the allocation must bear a reasonable relationship to the benefits received by the allocating governmental unit with general taxing powers. (Amounts allocated to subordinate entities, of course, reduce the aggegate amount of bonds that the entity making the allocation may issue directly, or through other subordinate entities, while remaining qualified for the small-issuer rebate exception.)

All allocations must be made in advance of issuance of the bonds, and once made, the allocations are irrevocable. Further in the case of entities subordinate to more than one allocating governmental unit with general taxing powers, only the proportionate part of the bonds represented by the benefit received by each allocating governmental unit be treated as issued by that unit provided allocations satisfying the criteria above are made in advance of issuance. Absent qualifying allocations, the entire amount of the bonds issued by such multi-jurisdictional issuers will be treated as issued by each governmental unit to which the issuer is subordinate.

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[7] Bonds issued before September 1, 1986, that would have qualified for the exception when issued had the new arbitrage restrictions applied to the issue of which they were a part are treated as satisfying this requirement.

Effective date

The amendments to the small governmental unit rebate exception apply generally to bonds issued after June 30, 1987. A special rule is provided permitting governmental units qualifying for the exception to elect to treat the amendments as if included in the Tax Reform Act of 1986 (i.e., as applying to bonds issued after August 31, 1986).

Exception for certain qualified student loan bonds

The Reform Act provides a transitional exception from the rebate requirement for temporary period earnings of certain qualified student loan bonds, which earnings are used to pay otherwise unreimbursed costs. The bill clarifies that (a) amounts paid by student loan borrowers as interest are not to be taken into account in determining whether an issuer is reimbursed for costs under this provision, and (b) in the case of bonds eligible for this rebate exception, except as provided otherwise in future Treasury regulations, amounts earned under the exception also may be taken into account in determining yield on the student loans (i.e., interest payments by student borrowers at rates generally established by the U.S. Department of Education for GSL and PLUS bonds, may continue to be treated as reimbursement for administrative expenses under present Treasury regulations).

Tax-exempt bonds treated as investment property

The bill deletes the rule allowing proceeds of governmental bonds and qualified 501(c)(3) bonds ("non-AMT bonds") to be invested in private activity bonds (other than qualified 501(c)(3) bonds) ("AMT bonds") without regard to otherwise applicable arbitrage yield restrictions. Thus, as with investment in taxable securities, non-AMT bond proceeds may not be invested in materially higher yielding AMT bonds except during permitted temporary periods or as part of a reasonably required reserve or replacement fund unless the investments comprise a permitted minor portion of the bond proceeds (sec. 148(c), (d), and (e)).

As a consequence of this amendment, the definition of nonpurpose investment (for purposes of the arbitrage rebate requirement) also is expanded to include AMT bonds acquired with the gross proceeds of an issue of non-AMT bonds. Thus, unless the gross proceeds of such a non-AMT issue are spent for the governmental purpose of the borrowing within six months after bonds are issued or the bonds are not subject to the rebate requirement because of the $5 million small-issuer exception, the arbitrage rebate requirement applies to the gross proceeds of the issue. Under the bill, therefore, the rebate requirement applies to an issue of non-AMT bonds if the proceeds are invested in AMT bonds with a purpose of realizing arbitrage profits since obligations acquired for such a purpose are nonpurpose investments. *See*, Treas. Reg. 1.103-13(b)(4)(iv)(A).

These provisions of the bill apply to bonds issued after March 31, 1988. No inference is intended by the adoption of this prospective effective date that the interest on non-AMT bonds issued before April 1, 1988, is tax-exempt where proceeds of the issue are invested in AMT bonds for arbitrage profit (other than during permitted temporary periods, as part of a reasonably required reserve or replacement fund or minor portion, or as part of an advance refunding escrow account). For example, it is understood that Treasury has been requested to review the tax-exempt status of some recent non-AMT issues where only an insignificant portion of the bond proceeds were to be spent directly to finance governmental activities, with the remainder being invested in AMT bonds to realize arbitrage profit. Treasury may achieve a substantive result similar to that provided by these technical amendments in cases such as these if it concludes that such issues are taxable under the over-issuance restrictions of present law, as reserve or replacement funds in excess of the maximum allowable size for such funds under present law, or because of other violations of present-law rules.

9. Prohibition of Federal guarantees

Present Law

Interest on Federally guaranteed bonds does not qualify for tax-exemption. An exception is provided (*inter alia*) for any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d), as such provision was in effect on July 18, 1984, if the bonds are issued before July 1, 1989.

The District of Columbia generally is not treated as a U.S. instrumentality for purposes of the Federal guarantee prohibition, and accordingly is permitted to issue tax-exempt obligations. The District is however treated as a U.S. instrumentality in the case of certain private activity bonds. Under the Act, these include exempt-facility, qualified small-issue, student loan, and qualified redevelopment bonds, if such bonds are secured other than as revenue bonds.

Explanation of Provision

The bill clarifies that the exception to the Federal guarantee prohibition for any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d), as such act was in effect on July 18, 1984 (i.e., the date of enactment of the Tax Reform Act of 1984), is a permanent provision.

The bill further clarifies that issuance of qualified redevelopment bonds by the District of Columbia is not precluded by the prohibition on Federal guarantee of tax-exempt bonds solely by virtue of a pledge of tax security as required for such bonds under the Code.

10. Change in use rules

Present Law

Under the Reform Act, deductions for interest and certain other charges are denied if property financed with private activity bonds is used in a manner not qualifying for tax-exempt financing with the type of bond involved at any time before the bonds are redeemed. Interest deductions may again be claimed once use of the property reverts to a use qualifying for tax-exempt financing.[8]

The legislative history accompanying the Reform Act provides that the change in use penalties apply to property financed with small-issue bonds as well as to other private activity bonds. Additionally, that legislative history states that a change in use resulting in loss of interest deductions occurs in the case of small-issue bonds if the special $10 million capital expenditure limit applicable to those bonds is violated.

Explanation of Provision

The bill clarifies that users of qualified small-issue bond proceeds, like users of the proceeds of other private activity bonds, are subject to the new change in use penalties. The bill codifies the rule that a change in use of facilities financed with qualified small-issue bonds is deemed to occur if post-issuance capital expenditures result in the $10-million small-issue size limitation being violated as well as when bond-financed facilities are used in a manner specifically prohibited by the Code.

The bill further clarifies that denial of interest deductions on residences financed with mortgage revenue bonds ceases if the housing is again used as a principal residence of the mortgagor.

Multifamily residential rental property bonds.—The bill clarifies that a prohibited change in use of property financed with multifamily residential rental property bonds issued before August 16, 1986 (or such bonds issued pursuant to sec. 1311 or 1317 of the Reform Act), does not occur when the bonds are refunded after August 15, 1986, solely because the property continues to meet the prior-law low-income set-aside requirement (as opposed to the revised set-aside rules of the Reform Act).

11. Bonds issued by certain volunteer fire departments

Present Law

Certain volunteer fire departments are qualified to issue tax-exempt bonds for specified purposes, notwithstanding that the fire departments may not be governmental units (or acting on behalf of such units) within the meaning of the Code and Treasury Department rules. The Reform Act does not specify whether these bonds are private activity bonds.

Explanation of Provision

The bill clarifies that bonds issued by certain volunteer fire departments (sec. 150(e)) are treated as private activity bonds only for purposes of the public approval requirement and the prohibition on advance refunding of private activity bonds.[9] (These bonds are treated as governmental bonds for all other Code purposes.)

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[8] The Reform Act is unclear as to the applicability of this rule to housing financed with mortgage revenue bonds.

[9] Qualified volunteer fire departments are treated as subordinate entities acting on behalf of the sponsoring governmental unit for purposes of sec. 148(f)(4)(C).

This extension to these bonds of the public approval requirement and the prohibition on advance refundings is effective for bonds issued after June 30, 1987.

12. Bonds issued under certain State programs

Present Law

The Reform Act authorizes tax-exemption for interest on bonds issued as part of the Texas Veterans' Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program. The Reform Act permits annual bond volume authority to be carried forward for most purposes for which private activity bonds may be issued. Carryforwards of annual bond volume authority are not addressed for bonds issued pursuant to these four programs.

Explanation of Provision

The bill clarifies that bonds issued under the Texas Veterans' Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program qualify for carryforward elections under the applicable private activity bond volume limitations, beginning with elections for the calendar year 1987 volume limitations. Further, the bill clarifies that bonds issued under the Iowa program are treated as satisfying the limitation on bond maturity to 120 percent of the economic life of the assets financed, if the weighted average maturity of the issue does not exceed 20 years.

13. Issuance of tax-exempt bonds by U.S. possessions

Present Law

Both prior law and the Reform Act permitted U.S. possessions to issue tax-exempt bonds where applicable organic Acts in conjunction with other provisions of U.S. law permitted such issuance. The Reform Act deletes, as deadwood, the term "Territory" from the the list of qualified issuers of tax-exempt bonds since the only Territories of the U.S. in recent history are now the States of Alaska and Hawaii. Bonds issued by U.S. possessions are subject to all Code requirements that would apply if the bonds were issued by or on behalf of [10] States or local governments.

Explanation of Provision

The deletion of the word "Territory" from the list of qualified issuers of tax-exempt bonds had no effect on the ability of U.S. possessions (*e.g.,* Puerto Rico, the Virgin Islands, American Samoa, and Guam) to issue tax-exempt bonds since those entities continue to be U.S. possessions for this purpose and are not Territories.

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[10] *See,* Treas. reg. sec. 1.103-1(b); Rev. Rul. 63-20, 1963-1 C.B. 24; and Rev. Proc. 82-26, 1982-1 C.B. 476.

14. Effective dates

Present Law

Mortgage credit certificate (MCC) targeting rules

The amendments to the mortgage credit certificate (MCC) targeting rules made by the Act apply to MCCs issued to qualifying homebuyers after August 15, 1986.

Rebate requirement for qualified veterans' mortgage bonds

Under the Act, the extension of the rebate requirement to all tax-exempt bonds generally applies for bonds issued after August 31, 1986 (in the case of certain bonds that were governmental bonds under prior law) or December 31, 1985 (in the case of most other bonds). A special effective date applies in the case of bonds used to fund certain pools. There is no general transitional exception to this requirement.

Prohibition of advance refunding of pension arbitrage bonds and bonds violating investment-type property restriction

The Act expands the arbitrage yield restrictions to apply to, *inter alia*, investments in annuity-type contracts (e.g., pension arbitrage bonds) and all other investment-type property. The restriction on annuity contract investments applies to bonds (including refunding bonds) issued after September 25, 1985. Otherwise, the expansion of the arbitrage restrictions of "all investment-type property" applies to bonds (including refunding bonds) issued after August 15, 1986 (August 31, 1986, in the case of certain governmental bonds, defined as under prior law).

Prohibition of abusive devices in connection with advance refundings

The Act prohibits the use of any device intended to produce arbitrage profits in connection with an advance refunding, effective with respect to bonds issued after December 31, 1986. No inference was intended by this prospective date that such devices were permitted before enactment of the Act.

Repeal of qualified mortgage bond policy statement requirement

Under prior law, issuers of qualified mortgage bonds and MCCs were required to submit to the Treasury Department annual statements explaining their policies in distributing bonds and credits. The Act repealed this requirement.

Restrictions on use of income of qualified scholarship funding corporations

The Reform Act provides that income of qualified scholarship funding corporations must be used for the purchase of additional student loan notes or paid over to the United States. Prior law had provided for payment to the State or local governmental unit chartering the corporation in lieu of payment to the United States. The Reform Act inadvertently omitted a separately stated effective date for this provision.

Explanation of Provisions

Mortgage credit certificate (MCC) targeting rules

The bill clarifies that the amendments to the MCC targeting rules are effective with respect to elections to trade-in qualified mortgage bond authority for authority to issue MCCs, which elections are made after August 15, 1986. Thus, credits for which elections to trade-in bond authority had been made before August 16, 1986, but which are actually distributed after that date, continue to be subject to the prior-law targeting rules.

Rebate requirement for qualified veterans' mortgage bonds

The bill clarifies that the arbitrage rebate requirement applies to current refundings of qualified veterans' mortgage bonds issued before August 16, 1986, if such refunding bonds are issued after June 30, 1987.

Prohibition of advance refunding of pension arbitrage bonds and bonds violating investment-type property restriction

The bill clarifies that the arbitrage restriction on investment in annuity contracts prohibits advance refundings (as well as new issues) of so-called "pension bonds" after June 10, 1987. Advance refunding of such bonds issued under specific transitional exceptions also is prohibited.

The bill further clarifies that the provision expanding the arbitrage restrictions to all "investment-type property" applies to advance refunding bonds issued after October 16, 1987.

Prohibition of abusive devices in connection with advance refundings

The bill clarifies that the Reform Act's prohibition on abusive devices in connection with advance refundings applies to bonds issued after August 31, 1986. As provided in the legislative history accompanying the Reform Act, no inference is intended that these devices were permitted under prior law.

Information reporting and public approval requirements

The bill clarifies that the extensions of the information reporting requirement to all bonds and of the public approval requirement to all private activity bonds apply to bonds issued after December 31, 1986. Bonds that were subject to these requirements under prior law continued to be so subject if issued between August 15, 1986, and January 1, 1987.

Repeal of qualified mortgage bond policy statement requirement

The bill clarifies that the repeal of the annual policy statement requirement for qualified mortgage bonds was effective for refunding bonds (as well as new money issues) issued after August 15, 1986.

Restrictions on use of income of qualified scholarship funding corporations

The bill clarifies that the effective date of the amendments related to use of the income of qualified scholarship funding corporations applies to distributions occurring after August 15, 1986, regardless of when the bonds to which the income relates were issued.

15. Transitional exceptions

Present Law

Transitional exception for certain advance refundings

A transitional exception to various requirements of the Act is provided for certain advance refunding bonds. Bonds that are IDBs or private loan bonds (as defined under prior law) may not be advance refunded under this exception.

Refundings of certain bonds issued pursuant to transitional exceptions

Bonds issued pursuant to general transitional exceptions

The Reform Act includes general transitional exceptions for certain bonds for facilities that were "in progress" on September 25, 1985 (Reform Act sec. 1312), and for certain current refundings of bonds originally issued before August 16, 1986 (Reform Act sec. 1313(a)).

As is true with other types of bonds, the Reform Act permits certain current refundings of mortgage revenue bonds and student loan bonds to occur without regard to the new targeting rules of the Act. The legislative history accompanying the Reform Act states that refundings are not intended to qualify for this transitional exception if the period for originating loans under the refunding bonds extends more than three years after the date the refunded (original bonds in the case of a series of refundings) bonds were issued.

Bonds issued pursuant to certain project-specific exceptions

Under the Reform Act, project-specific transitional exceptions generally are limited to a specified amount of bonds (Reform Act secs. 1316(g) and 1317). The treatment of current refunding issues for purposes of these limitations is not specified.

Treatment for volume limitation purposes

Advance refundings of certain output facility bonds

The State private activity bond volume limitations generally are effective for bonds issued after August 15, 1986. Transitional exceptions are provided under specified circumstances (Reform Act sec. 1315).

A special rule applies to advance refundings of bonds issued before August 16, 1986, if the bonds were governmental bonds when issued. Under this rule, the refunding bonds are subject to the volume limitation, to the extent of the nongovernmental use of issue in excess of $15 million, if 5 percent or more of the proceeds of the issue was used to finance output facilities (other than facilities for furnishing water).

Qualified redevelopment bonds

Under the Reform Act, bonds issued pursuant to project-specific transitional exceptions (Reform Act sec. 1317), and which would not have been subject to volume limitations under prior law, are exempt from the new private activity bond volume limitation.

The Reform Act provides project-specific transitional exceptions for bonds to finance several redevelopment projects (Reform Act sec. 1317(6)). The Reform Act specifies that bonds issued pursuant to these exceptions are to be treated as bonds which would not have been subject to volume limitations under prior law. (*See*, Reform Act sec. 1315(e).)

Treatment under alternative minimum tax of bonds issued pursuant to transitional exceptions

Interest on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986,[11] is treated as a preference item for purposes of the alternative minimum tax. This treatment does not apply to refundings (including a series of refundings) of bonds originally issued before August 8, 1986.

Under a special provision, interest on bonds issued pursuant to certain project-specific transitional exceptions (Reform Act sec. 1317) is not treated as a preference item, if the bonds would not have been IDBs or private loan bonds under prior law. Bonds issued pursuant to the general transitional exceptions for certain "in progress" facilities and for certain refunding bonds, as well as exceptions for bonds transitioned under prior tax Acts which exceptions are reenacted (Reform Act sec. 1316(g)), are not eligible for this exception. Interest on these bonds is therefore a preference item under the alternative minimum tax if the bonds are private activity bonds, as defined under present law.

Carryforwards for certain bonds issued pursuant to transitional exceptions

The Reform Act contains no general rule allowing volume cap carryforwards for bonds issued pursuant to transitional exceptions. Certain transitioned bonds (e.g., bonds which are specifically described as belonging to a category for which carryforward elections are permitted under present law) may qualify for carryforward elections under the substantive volume limitation rules.

Project-specific transitional exceptions

The Reform Act provides transitional exceptions to indicated provisions for various specifically described projects.

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[11] This date is extended to August 31, 1986, in the case of certain bonds that were governmental bonds under prior law.

Explanation of Provisions

Transitional exception for certain advance refundings

Under the Reform Act, bonds that are IDBs or private loan bonds (as defined under prior law) do not qualify under the transitional exception for certain advance refunding bonds (Reform Act sec. 1313(b)). The bill clarifies that the determination of whether a bond is a private loan bond is to be made without regard to any exception to the private loan bond definition, except the exception for so-called "excluded loans" (former sec. 103(o)(2)(C)). Thus (e.g.), IDBs, mortgage revenue bonds and student loan bonds are treated as private loan bonds for purposes of this provision, and may not be advance refunded under the transitional rule; however, bonds used to make loans that enable the borrower to finance a governmental tax or assessment of general application for an essential governmental function may qualify under the transitional exception provided the tax-assessment bonds would not have been IDBs under the prior-law definition.

Refundings of certain bonds issued pursuant to transitional exceptions

Bonds issued pursuant to general transitional exceptions

"In-progress" project rule.—The bill clarifies the conditions under which bonds issued pursuant to the general transitional exception for certain "in-progress" projects (Reform Act sec. 1312) may be currently refunded, while continuing to qualify for transitional relief. Such bonds are required to meet satisfy both (a) the provisions of the Reform Act that apply to bonds issued under the transitional exception for in-progress projects (Reform Act sec. 1312(b)(1)), and (b) the provisions that apply under the general transitional exception for current refunding bonds (Reform Act sec. 1313(b)(3)).

Qualified mortgage bonds and student loan bonds.—The bill codifies the statements in the legislative history concerning the maximum loan origination periods for refundings of qualified mortgage bonds and student loan bonds. Under the bill, the new targeting rules for qualified mortgage bonds apply to all loans made from the proceeds of refunding bonds, which loans are originated more than three years after the date the refunded bonds (original bonds in the case of a series of refundings) were issued. This requirement applies both to loans originated from original proceeds of the borrowing and to loans originated from prepayments of mortgage loans.

Similarly, in the case of student loan bonds, the new Code requirements apply to loans originated more than three years after the date the refunded bonds (original bonds in the case of a series of refundings) were issued. In the case of refundings of student loans issued in connection with the Federal GSL and PLUS programs, the applicable requirements are those for GSL and PLUS program bonds issued under the 1986 Code. The rule does not permit conversion of these Federally guaranteed bonds into supplemental student loan bonds.

These codifications for mortgage revenue bonds and student loan bonds apply to refunding bonds issued after October 16, 1987.

Bonds issued pursuant to certain project-specific exceptions

Where a transitional exception is limited to a specified amount of bonds (Reform Act secs. 1316(g) and 1317), the bill clarifies that bonds issued pursuant to the exception may be currently refunded, under specified circumstances, without the refunding counting against this dollar limit. This allowance applies to a refunding (including a series of refundings) of a transitioned bond, provided that—

(a) the weighted average maturity of the refunding issue does not exceed the weighted average maturity of the refunded bonds;

(b) the amount of the refunding bond does not exceed the outstanding principal amount of the refunded bond; and

(c) the refunded bond is redeemed within 90 days of the issuance of the refunding bond.

Treatment for volume limitation purposes

Advance refundings of certain output facility bonds

The bill clarifies that the rule subjecting the private use portion of advance refundings of pre-August 16, 1986, bonds to the State private activity bond volume limitations, if 5 percent or more of the net proceeds were used for output facilities, applies notwithstanding the general transitional exception contained in Reform Act section 1315 for certain bonds that were governmental bonds under prior law.

Qualified redevelopment bonds

Qualified redevelopment bonds that are the subject of project-specific transitional exceptions (Reform Act sec. 1317(6)) generally are exempt from the new State volume limitations. The bill clarifies that this treatment does not apply to any bonds issued pursuant to these exceptions which would have been tax-exempt IDBs (as defined under the 1954 Code) if the bonds had been issued before August 16, 1986. (Bonds for a purpose that would not have qualified for tax-exemption under prior law may not be issued under these transitional exceptions.)

This provision is effective for bonds issued after June 10, 1987.

Treatment under alternative minimum tax of bonds issued pursuant to transitional exceptions

The bill clarifies the treatment under the individual and corporate alternative minimum taxes of interest on bonds issued pursuant to various transitional exceptions. Under this clarification, interest on bonds issued pursuant to transitional exceptions generally is not treated as a preference item for purposes of the individual or corporate alternative minimum taxes, unless the bonds would have been IDBs or private loan bonds if issued on August 7, 1986. This clarification applies to bonds issued pursuant to the general transitional exceptions for certain bonds (Act sec. 1312), the continuing exceptions for certain bonds that received transitional relief under prior tax acts (Act sec. 1316(g)), and project-specific transitional exceptions (Reform Act sec. 1317). The clarification does not apply to refunding bonds which are subject to the transitional exceptions contained in the minimum tax provisions of the Reform Act.

Carryforwards for certain bonds issued pursuant to transitional exceptions

The bill clarifies that carryforward elections under the new State volume limitations are permitted for bonds (except qualified small-issue bonds) issued pursuant to transitional exceptions (e.g., bonds authorized under Reform Act secs. 1312 and 1317).

Amendments to project-specific transitional exceptions

The bill clarifies that the new limitations on bond-financing of costs of issuance (sec. 147(g)) apply to bonds issued pursuant to project-specific transitional exceptions (Reform Act sec. 1317), unless otherwise expressly provided.

The bill further makes various amendments to project-specific transitional exceptions contained in the Reform Act. Among these amendments is a clarification that bonds authorized to be issued in excess of the $150 million limitation on outstanding nonhospital bonds for section 501(c)(3) organizations under the project-specific transitional exceptions are in addition to any such bonds authorized under a generic transitional exception to the Reform Act (Reform Act sec. 1313(b)). Further, issuers may elect which exception to apply first—the project-specific exception or the generic exception. All transitioned bonds count toward the $150 million limit in determining the amount of additional bonds from which a section 501(c)(3) organization may benefit in the future.

Further, these transitional bonds need not be the first bonds issued by the issuer after the effective date of the new provisions. For example, if bonds are issued to finance airport facilities and the issue qualifies under all provisions of the Reform Act, these bonds do not count against any transitional exception provided for that airport. Thus, a subsequent issue may be issued containing the full amount of the transitioned bonds.

XIV. TRUSTS AND ESTATES; UNEARNED INCOME OF CERTAIN MINOR CHILDREN; GENERATION-SKIPPING TRANSFER TAX (SEC. 114 OF THE BILL)

A. Income Taxation of Trusts and Estates

1. Grantor treated as holding any power or interest of grantor's spouse (sec. 114(a) of the bill, sec. 1401 of the Reform Act, and sec. 672 of the Code)

Present Law

The grantor of a trust is treated as the owner of the trust's assets if he retains certain powers or interests over all or a portion of the trust (sec. 671-678). In that situation, the income and deductions of the portion are taxed directly to the grantor. The grantor is not, however, treated as the owner by virtue of certain powers exercisable by trustees, none of whom is the grantor and not more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. The grantor also is treated as the owner of a trust if the trust makes certain loans to him.

The grantor is treated as holding all powers and interests of the grantor's spouse if the grantor's spouse is living with the grantor when such interests and powers are created.

Explanation of Provision

The bill provides that the grantor will be treated as holding any power or interest that was held by an individual either (1) who was the grantor's spouse at the time that the power or interest was created or (2) who became the grantor's spouse subsequent to the creation of that power or interest. For this purpose, individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance.

In addition, the grantor is treated as owner of a trust by virtue of certain powers exercisable by trustees if the grantor's spouse is a trustee or more than half of the trustees are related or subordinate parties subservient to the wishes of the spouse. The grantor also is treated as the owner where the trust makes certain loans to the grantor's spouse.

2. Limitations to reversionary interest rule exceptions (sec. 114(b) of the bill, sec. 1402 of the Reform Act, and sec. 673 of the Code)

Present Law

The grantor is treated as the owner of trust property where the grantor or the grantor's spouse has a reversionary interest whose value is more than 5 percent of the value of the trust at the time of the inception of the trust.

Explanation of Provision

The bill provides that, in determining whether an reversionary interest has a value in excess of 5 percent of the trust, it will be assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest. In addition, the bill reenacts a provision of prior law which provides rules for postponements of the date of a reversionary interest. This provision was deleted by the Reform Act, but is necessary where the date of the reversionary interest is after the life of an individual and that date is later postponed.

3. Taxable year of trusts (sec. 114(c) of the bill and sec. 1403 of the Reform Act)

Present Law

Trusts are required to use a calendar year as their taxable year, effective for taxable years beginning after December 31, 1986. The taxable income of any beneficiary of a trust that is attributable to the trust's short taxable year arising from a required change of its taxable year to a calendar year is to be included in the beneficiary's income over a four year period beginning with the year of change.

Explanation of Provision

The bill provides that beneficiaries of charitable remainder trusts (described in sec. 664) may elect the four-year spread from a required change of a taxable year.

The bill also specifies that any trust beneficiary may elect to include the taxable income attributable to the required change in the trust's taxable year in the year of change.

The bill provides that trusts required to change their taxable year must annualize any income earned in the short year.

4. Application of four year spread to tiered pass-through entities (sec. 114(c) of the bill, and secs. 806 and 1403(c) of the Reform Act)

Present Law

Owners of partnerships, S corporations and trusts are permitted to take into income over a four-year period items attributable to the short taxable year required by reason of changes made in the 1986 Act.[1]

Explanation of Provision

The bill clarifies that a pass-through entity that is required to change its taxable year by the 1986 Act and owns an interest in a pass-through entity that also was required to change its taxable year by the 1986 Act will not be allowed the four year spread. A pass-through entity is any partnership, S corporation, common trust fund, or trust.

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[1] The bill would require that common trust funds adopt a calendar year and permit participants in such funds to include in income items from the short taxable year over a four period.

5. Estimated taxes of trusts and estates (sec. 114(d) of the bill, sec. 1404 of the Reform Act, and sec. 6654 of the Code)

Present Law

Trusts and estates generally are required to pay estimated taxes in the same manner as individuals. Estates, however, do not pay estimated taxes for taxable years ending within two years of the decedent's death. Such treatment does not extend to revocable trusts, which sometimes serve as estate substitutes.

Within 65 days of the close of the trust's taxable year, the trustee may elect, in substance, to distribute any excess estimated payments to the trust beneficiaries. This election is made on the trust's tax return for that year.

A taxpayer may satisfy the obligation to pay estimated taxes by paying an annualized income installment which is determined by reference to the months in the year ending before the due date of the installment.

Explanation of Provision

The bill exempts a grantor trust which receives the residue of the probate estate under the grantor's will from payment of estimated taxes with respect to taxable years ending before two years after the grantor's death.

The bill provides that the individual estimated tax provisions do not apply to a trust subject to tax under section 511 or to any private foundation.[2] In addition, the bill clarifies that the election to distribute excess estimated tax payments to beneficiaries need not be made on the tax return for the trust for the preceding year, but may be made in a manner prescribed by the Secretary of the Treasury. The bill also provides that, in the case of a taxable year reasonably expected to be the last taxable year of an estate, the fiduciary may distribute excess estimated tax payments to the estate's beneficiaries.

The bill grants one additional month for the computation of estimated taxes required to be paid by trusts and estates. This is done by amending the annualization rule for these entities so that each payment is computed for a period one month shorter than under present law. Thus, these entities will generally have 45 days (instead of 15 days) to compute their estimated tax payments under the annualization rule. The dates the estimated tax payments are due are not altered.

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[2] See section 115(h) of the bill, clarifying the application of the corporate estimated tax requirements to these organizations.

B. Taxation of Unearned Income of Minor Children (sec. 114(e) of the bill, sec. 1411 of the Reform Act, and secs. 1 and 59 of the Code)

Present Law

The unearned income of a child under age 14 in excess of $1,000 is taxed to the child at the highest marginal rate of the child's parents. This tax is determined by calculating the additional tax that the parents would pay if the parents' income included the unearned income of the child in excess of $1,000. In making this calculation, the amount of the parents' deductions and credits are not affected by the inclusion of any of the child's unearned income in the parents' income. The Secretary of the Treasury is to issue regulations providing for the application of these rules where the minor child or his parents is subject to the alternative minimum tax.

Where an individual transfers appreciated property to a trust and the trust disposes of such property within 2 years of the transfer, the tax on the built-in gain at the time of the transfer to the trust is determined at the highest marginal rate of the transferor for the year of sale (sec. 644).

Explanation of Provision

Computation of child's tax where parents' rates are used to determine tax of trust

The bill provides that, where parents marginal tax brackets are being used to determine both the income tax of a trust under section 644 and the income tax of their minor children under section 1(i), the tax of the trust is determined first without regard to the income of the minor child and then the tax of the minor child is determined by including the gain of the trust which is taxable under section 644 in the income of the parent. The bill also provides that the determination of the tax of the child does not affect the amount of any "exclusion," as well as any deduction or credit, of the parents.

Alternative minimum tax

The bill also provides that the alternative minimum tax imposed on the net unearned minimum taxable income of a child under 14 years of age will not be less than the alternative minimum tax which would have been imposed on the parents had that income been included in the parents' alternative minimum taxable income. The amount of minimum tax which would have been imposed on the parents is computed by including the child's net unearned minimum taxable income in the alternative minimum taxable income of the parents, and by increasing the parents' regular tax by the amount of the child's regular tax imposed on the net unearned income of the child. For this purpose, net unearned minimum taxable income means net unearned income (i.e., unearned income in excess of $1,000) computed by taking into account the preferences and adjustments provided in sections 56, 57 and 58.

For example, assume that the child's net unearned income (as defined in sec. 1(i)(4)) is $10,000 and the unearned minimum taxable income (as defined in sec. 59(j)(3) as added by the bill) is $20,000, by reason of the child having $10,000 of tax-exempt interest on newly issued private activity bonds. Assume that the parents are subject to the alternative minimum tax for the taxable year and that the parents' marginal rate for purposes of the regular tax is 28 percent. Under the rules of section 1(i), the child's regular tax on the net unearned income is $2,800. The child is not subject to the alternative minimum tax (determined without regard to this provision) by reason of the $30,000 exemption amount. Under the bill, the child's minimum tax will be $1,400 (21 percent of $20,000 ($4,200) less 28 percent of $10,000 ($2,800)). If, however, the parents would not have been subject to the alternative minimum tax (taking into account the net unearned minimum taxable income and the regular tax of the child) because their regular tax exceeded their tentative minimum tax, no minimum tax would be imposed on the child.

C. Estate Tax

1. Filing estate tax current use valuation elections (sec. 114(f) of the bill, sec. 1421 of the Reform Act, and sec. 2032A of the Code)

Present Law

Estates of individuals dying before January 1, 1986, that substantially complied with the requirements enumerated on the Federal estate tax return for electing current use valuation are allowed to perfect defective elections within 90 days of being notified of errors by the Secretary of the Treasury (the "substantial compliance rule"). Such election must have been within the time prescribed for filing such return, including extensions thereof.

Explanation of Provision

The bill clarifies that, in order to qualify for the substantial compliance rule, the election need only have been made on a Federal estate tax return which was timely within the meaning of section 2032A(d)(1). Thus, that rule is available for a defective election made on a late filed return so long as that return is the first return filed.

D. Generation-Skipping Transfer Tax

1. Overlap of direct skips and taxable terminations and distributions (secs. 114(g)(3), (g)(15), (h)(3) of the bill, sec. 1431 of the Reform Act, and sec. 2611 of the Code)

Present Law

A "direct skip" is defined as a transfer subject to estate or gift tax of an interest in property to a skip person. A "taxable termination" is defined as a termination of an interest in property held in trust if (1) there is no nonskip person who has an interest in the trust after the termination or (2) at no time after the termination may a distribution be made from that trust to a nonskip person. A "taxable distribution" is defined as a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Excluded from the definition of direct skips are (1) certain transfers to a grandchild where the parent of the grandchild is dead (the "predeceased parent rule") and (2) certain transfers prior to January 1, 1990, of less than $2 million (the "$2 million exemption").

Explanation of Provision

The bill provides that a transfer that meets the definitions of both a direct skip and a taxable termination will be treated as a direct skip. For example, where an individual transfers property into a trust that is to pay income to that individual for his life and, after that individual's death, to pay the remainder to that individual's grandchild, there is both a direct skip and a taxable termination under present law at the death of that individual. Under the bill, the transfer would be treated as a direct skip from the individual to the individual's grandchild (and not as a taxable termination) at the time of that individual's death.

The bill also clarifies that transfers which do not constitute direct skips because of the deceased parent rule or the $2 million exemption also do not constitute taxable terminations or distributions.

2. Treatment of certain charitable interests (sec. 114(f)(4) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code)

Present Law

The amount of the generation-skipping transfer tax is determined by multiplying the amount involved by the "applicable rate." The "applicable rate" is the product of the maximum Federal estate tax rate and the "inclusion ratio," and the "inclusion ratio" is the excess of 1 over the "applicable fraction." The "applicable fraction" is a fraction the numerator of which is the portion of the $1 million exemption allowed each individual that is allocated to this transfer and the denominator of which is the value of the property transferred to the generation-skipping trust. For transfers made in trust (which are not direct skips), the denominator is reduced by (1) any Federal estate or State death taxes recovered from the trust and (2) any charitable deduction with respect to the property, based on the present value of the charitable interest.

The effect of deducting the present value of any charitable lead annuity interest from the denominator of the applicable fraction is to permit leveraging of the exemption amount. Thus, if the trust assets sufficiently outperform the rate of return assumed in computing the present value of the charitable interest, the amount passed to noncharitable persons can exceed the amount which would have been passed to them had there been no charitable interest in the trust.

Explanation of Provision

The bill provides that the applicable fraction of a charitable lead annuity trust shall be a fraction, the numerator of which is the adjusted GST exemption and the denominator of which is the value of all property in the trust immediately after termination of the charitable lead interest. The adjusted GST exemption is an amount equal to the GST exemption allocated to the trust increased by the interest rate used in determining the charitable deduction for Federal gift or estate tax purposes for the actual period of the charitable lead annuity. Thus, the adjusted GST amount equals the claimed exemption increased at the applicable interest rate used when the trust was created. The claimed exemption is increased by the applicable interest rate for each year of the actual length of the charitable interest, determined when the interest terminates.

A charitable lead annuity is an interest in the form of a guaranteed annuity with respect to which a deduction was allowed for Federal gift or estate tax purposes. The bill does not affect the treatment of other charitable trusts.

The provision is effective for transfers made after October 13, 1987.

3. Special rule for determination of inclusion ratio where inter vivos transfers are includible in transferor's gross estate (sec. 114(g)(5) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code)

Present Law

The "inclusion ratio" is used to establish the rate of tax which is imposed on the generation-skipping transfer. It is the ratio the numerator of which is the amount of the $1 million exemption allowed to every individual that the transferor has allocated to a particular transfer and the denominator of which is the value of the property transferred to the trust reduced by any Federal or State death taxes recovered from the trust and the present value of any charitable interests in the trust.[3] Where any of the $1 million exemption is allocated to property transferred at or after the death of the transferor, the value of the property is its value for Federal estate tax purposes. Where any of the $1 million exemption is allocated on a timely filed Federal gift tax return, the value of the property is its value for Federal gift tax purposes. Where any of the $1 million is allocated during the lifetime of the transferor but not on a timely filed Federal gift tax return, the value of the property is determined at the time that the allocation is filed with the Internal Revenue Service.

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[3] The bill modifies the allowance of the charitable deduction for purposes of determining the inclusion ratio for charitable lead annuity trusts.

Explanation of Provision

The bill provides that no allocation of any portion of the transferor's $1 million exemption may be made to any property that is transferred by the transferor during his lifetime, but would be includible in the transferor's gross estate (other than pursuant to sec. 2035) until the end of the estate tax inclusion period. If such transfer is a direct skip to a trust, the skip will be treated as occurring as of the close of the estate tax inclusion period.

The estate tax inclusion period is the period during which the transferred property would be includible in the transferor's gross estate if he had died. In no event does it extend beyond the earlier of the date of (1) a generation-skipping transfer with respect to the property or (2) the transferor's death.

If the property is includible in the transferor's estate, the value used in determining the inclusion ratio is its value for Federal estate tax purposes. If the property is not so includible, the value used in determining the inclusion ratio is the value of the property as of the close of the estate tax inclusion period, or if a GST allocation is not made on a timely filed Federal gift tax return, the value of the property as of the time the allocation is filed.

4. Valuation of property transferred in trust for purposes of computing inclusion ratio (sec. 114(f)(5) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code).

Present Law

The inclusion ratio is computed by reference to the value of the property transferred to the trust. With several exceptions, the value of the property is determined at the time of the transfer to the trust.

Explanation of Provision

The bill clarifies that, unless certain requirements prescribed by the Secretary of the Treasury are met,[4] the value of property transferred to a trust after death shall be determined as of the time of the transfer to the trust.

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[4] It is expected that the Secretary of the Treasury will require that the assets transferred to trust be fairly representative of the appreciation or depreciation in the value of all property available for such transfer. See Rev. Proc. 64-19, 1964-1 C.B. 682.

5. Definition of skip person involving trusts (sec. 114(g)(6) of the bill, sec. 1431 of the Reform Act, and sec. 2613 of the Code)

Present Law

Under present law, a "skip person" is defined to mean either (1) a person assigned to a generation that is two or more generations below that of the transferor or (2) a trust all the interests of which are held by such persons or which at no time can make distributions to persons assigned to a generation less than two generations below that of the transferor (sec. 2613(a)). Also under present law, a trust generally is a person (sec. 7701(a)(1)).

If an estate, trust, partnership, corporation, or other entity has an interest in property, each individual having a beneficial interest in such entity is treated as having an interest in that property and is assigned to a generation under normal generation assignment rules consistent with that beneficial interest (sec. 2651(e)(2)).

Explanation of Provision

The bill clarifies the definition of a "skip person" by providing that a skip person must be a "natural person" whose generation assignment is two or more generations below that of the transferor (i.e., category (1), above). In addition, the bill provides that the determination of whether a trust is a "skip person" (i.e., category (2), above) is to be determined without regard to the entity look-through rules as they apply to trusts.

6. Disregard of support obligations as an interest (sec. 114(g)(7) of the bill, sec. 1431 of the Reform Act, and sec. 2652 of the Code)

Present Law

In order to determine whether there is a taxable termination (sec. 2612(a)), whether property is transferred to a skip person (sec. 2612(c)), and whether property qualifies for the $2 million exemption for transfers to grandchildren, it is necessary to determine which persons have an "interest" in the trust. A person generally is treated as having an interest in a trust if that person has a right (other than a future right) to receive income or corpus from the trust or is a permissible current recipient of income or corpus from the trust.

Explanation of Provision

The bill provides that any income or corpus of the trust that may be used to satisfy any obligation of support arising by reason of State law is to be disregarded in determining whether a person has an interest in a trust if such use is discretionary or pursuant to any State law substantially equivalent to the Uniform Gifts to Minors Act. Thus, a parent is not treated as having an interest in a trust by reason of powers he may have as a guardian for the child. On the other hand, a parent will be treated as having an interest in a trust if the trust instrument mandates that trust assets be used to discharge a support obligation.

7. Taxation of multiple skips (sec. 114(g)(8) of the bill, sec. 1431 of the Reform Act, and sec. 2612(c) of the Code)

Present Law

There is no generation-skipping transfer tax on what otherwise would be a direct skip where property is transferred from the transferor to the grandchild of the transferor or to a trust for the benefit of such a grandchild if the parent of the grandchild is deceased at the time of the transfer (sec. 2612(c)). This is accomplished by deeming the generation assignment of the grandchild to "step up" to the generation of the child.

There is, however, no adjustment in generation assignment for transfers from trusts. Thus, if property is transferred by a grandparent to a trust for the exclusive benefit of the transferor's grandchild, distributions from the trust to the grandchild would be taxable distributions even though the grandchild's parents were deceased when the trust was created.

Explanation of Provision

The bill applies the step-up rule of section 2612(c) to transfers from the portion of a trust attributable to a transfer of property which would have been a generation-skipping transfer but for the predeceased child rule of section 2612(c). Thus, where a grandparent transfers property to a trust which is to pay income to the grandparent's grandchildren for life, distributions to a grandchild would not be a taxable distribution if the grandchild's parents were deceased at the time of the transfer to the trust. Distributions to a grandchild whose parents were not deceased at the time of the transfer to the trust would constitute taxable distributions.

8. Certain interests disregarded (sec. 114(g)(9) of the bill, sec. 1431 of the Reform Act, and sec. 2652(c)(2) of the Code)

Present Law

The determination of whether a trust is a generation-skipping trust depends upon whether a beneficiary has an "interest" in the trust. A person generally has an interest in property if he has a right (other than a future right) to receive income or corpus from the trust or is a permissible current recipient of income or corpus from the trust. Nonetheless, present law provides that an interest that is used primarily to postpone or avoid the generation-skipping transfer tax is disregarded in applying the generation-skipping transfer tax.

Explanation of Provision

The bill clarifies the rule of present law that disregards interests primarily used to postpone or avoid the generation-skipping transfer tax by removing any suggestion that the interest to be disregarded must be nominal and by providing that the rule applies if the primary purpose of the interest is to avoid any generation-skipping transfer tax. For example, if a transferor placed property in trust which is to pay income to a great grandchild for a relatively short period, then income to a grandchild for life, with remainder going back to a great grandchild, in order to avoid a second imposition of the generation-skipping transfer tax, the income interest of the great grandchild would be disregarded so that there would be a generation-skipping transfer tax at the death of the grandchild. That interest would be disregarded even though distributions to the great grandchild are taxable distributions.

9. Definition of transferor (sec. 114(g)(10) of the bill, sec. 1431 of the Reform Act, and sec. 2652 of the Code)

Present Law

The term "transferor" is defined to mean the decedent, in the case of a transfer of a kind subject to the Federal estate tax, or the donor, in the case of a transfer of a kind subject to the Federal gift tax. In some cases, it is possible for property to be subject to Federal estate or gift tax even though there is no transfer of such property under local law at such time. For example, in the case of a trust which is to pay income to the transferor for life, then income to the transferor's child for life, remainder to the transferor's grandchild, the property is includible in the gross estate of the transferor, even though there is no transfer of the trust assets under local law at the time of the transferor's death.

Explanation of Provision

The bill clarifies the definition of "transferor" by providing that a person is treated as the transferor of any property included in that person's gross estate or with respect to which that person has made a gift. Thus, a person can be a transferor even though there is no transfer of property under local law at the time the property is subject to Federal estate or gift tax. The transferor is treated as transferring any property with respect to which that person is the transferor.

10. Regulatory authority to prescribe rules dealing with trust equivalents (sec. 114(g)(11) of the bill, sec. 1431 of the Reform Act, and sec. 2663 of the Code)

Present Law

The generation-skipping transfer tax is imposed on generation-skipping trusts. For this purpose, a trust is any arrangement (other than an estate) which has substantially the same effect as a trust. Examples of such arrangements include life estates and remainders, estates for years, and insurance and annuity contracts.

Explanation of Provision

The bill provides the Secretary of the Treasury with authority to prescribe regulations modifying the generation-skipping transfer tax rules generally applicable to trusts in the case of trust equivalents. For example, where the generation-skipping arrangement is in the form of an insurance or annuity contract, it is possible that the Secretary of the Treasury may exercise the authority granted by this section of the bill to provide that the beneficiary of the insurance or annuity contract pay any generation-skipping transfer tax.

11. Generation assignment of governmental entities (sec. 114(g)(12) of the bill, sec. 1431 of the Reform Act, and sec. 2651(e)(3) of the Code)

Present Law

In general, persons who are related to the transferor are assigned to a generation based upon their relationship to the transferor. Persons who are not related to the transferor are assigned to a generation based upon the difference in age between that person and the transferor. Charitable organizations (described in secs. 511(a)(2) and (b)(2)) are assigned to the same generation as that of the transferor.

Explanation of Provision

The bill provides that any governmental entity is assigned to the same generation as that of the transferor. The rule applies to all governmental entities, including the United States Government, the government of any State, and the government of any foreign country.

12. Basis of property after a taxable termination (sec. 114(g)(13) of the bill, sec. 1431 of the Reform Act, and sec. 2654 of the Code)

Present Law

Where property is subject to a generation-skipping transfer tax, the basis of the property immediately after the generation-skipping transfer tax generally is its basis immediately before the imposition of the generation-skipping transfer tax increased (but not in excess of the property's fair market value at such time) by the portion of the generation-skipping transfer tax attributable to any appreciation in the property at such time. Nonetheless, where property is entirely subject to a generation-skipping transfer tax at the same time as, and as a result of, the death of an individual, the basis of the property immediately after the imposition of the generation-skipping transfer tax generally is its fair market value at such time. Where only a portion of the property is subject to the generation-skipping transfer tax (because the inclusion ratio is less than 1), any increase in basis to the property's fair market value basically is limited to the portion of the property subject to the generation-skipping transfer tax (i.e., the amount of appreciation in the property multiplied by the inclusion ratio).

Explanation of Provision

The bill provides that, where the basis of property that has been subject to a generation-skipping transfer tax is to be determined by reference to its fair market value (because the generation-skipping transfer tax occurs at the same time as and as a result of the death of an individual) and the inclusion ratio is less than 1, any decrease in basis (as well as any increase in basis) is limited by the decrease in the value of such property multiplied by the inclusion ratio.

13. Treatment of single trust as multiple trusts (sec. 114(g)(14) of the bill, sec. 1431 of the Reform Act, and sec. 2654 of the Code)

Present Law

The generation-skipping transfer tax is imposed on direct skips and taxable terminations and taxable distributions from a generation-skipping trust. The impact of the generation-skipping transfer tax sometimes depends upon whether assets are transferred in one trust or in more than one trust. For example, where transfers that qualify for the $10,000 annual exclusion are made to a generation-skipping trust that has an inclusion ratio greater than zero, a portion of such transfers may later be subject to a generation-skipping transfer tax as a taxable termination or taxable distribution, even though such transfers would never be subject to the generation-skipping transfer tax if made to a separate trust that has a zero inclusion ratio.

Explanation of Provision

The bill provides that a single trust generally may not be treated as two separate trusts for purposes of the generation-skipping transfer tax. However, portions of a trust attributable to transfers from different transferors, and substantially separate and independent shares of different beneficiaries in a trust, shall be treated as separate trusts.

The bill does not affect the treatment of trusts which are separate trusts under state law.

14. Special election for qualified terminable interest property (sec. 114(f)(16) of the bill, sec. 1431 of the Reform Act, and sec. 2652(a)(3) of the Code)

Present Law

The term "transferor" is defined to mean the decedent, in the case of a transfer of a kind subject to the Federal estate tax, or the donor, in the case of a transfer of a kind subject to the Federal gift tax.[5] In the case of any property which has been elected to be treated as qualified terminable interest property (QTIP) for Federal estate and gift tax purposes, the estate of the decedent or the donor spouse may elect to treat the property for generation-skipping transfer tax purposes as if no QTIP election had been made. Thus, under the election, the donor or decedent spouse would be treated as the transferor for generation-skipping transfer tax purposes, even though the property is treated as passing to the donee or surviving spouse for Federal estate and gift tax purposes.

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[5] The bill would replace "a transfer of a kind" with "any property."

Explanation of Provision

The provision clarifies that the election to treat property as if no QTIP election had been made must be made with respect to all the property in the QTIP trust. For example, if a spouse makes a QTIP election with respect to $1.4 million of a $2 million trust, he must elect with respect to the entire $1.4 million in order to make the generation-skipping election.

15. Certain partial terminations treated as taxable terminations (sec. 114(g)(17) of the bill, sec. 1431 of the Reform Act, and sec. 2612(a) of the Code)

Present Law

If a taxable termination occurs with respect to a trust at the same time as, and as a result of, the death of an individual, an election may be made to value the property included in the termination under the alternate valuation rule provided in section 2032.

If a specified portion of the trust assets are distributed to certain persons upon the termination of an interest in property held in trust, the termination shall be considered a taxable termination with respect to such portion of trust property and will be eligible for alternate valuation. This treatment is limited to distributions to skip persons who are lineal descendents of the holder of the interest.

Explanation of Provision

The bill provides that the distribution of a specific portion of trust assets will be treated as a taxable termination only if it occurs upon the termination of an interest in property by reason of the death of a lineal descendant of the transferor. Such treatment will not depend upon the identity of the skip person.

16. Treatment of certain nontaxable gifts (sec. 114(g)(19) of the bill, sec. 1431 of the Reform Act, and sec. 2642(c) of the Code)

Present Law

The applicable rate for the generation-skipping transfer tax equals the maximum Federal estate tax rate times the inclusion ratio with respect to the transfer. For trusts, the inclusion ratio equals the excess of one over a fraction, the numerator of which is the amount of GST exemption allocated to the trust, and the denominator of which is the value of the property transferred to the trust, with certain reductions.

A nontaxable gift is any transfer of property to the extent such transfer is not treated as taxable because of certain exclusions. Nontaxable gifts which are direct skips have a zero inclusion ratio. Nontaxable gifts to trusts which are not direct skips generally are not taken into account in determining the inclusion ratio of the trust. The effect of a nontaxable gift which is a direct skip to a trust upon the trust's inclusion ratio is unclear.

Under present law, it is possible that transfers constituting nontaxable gifts made to a trust may not be taken into account in determining the inclusion ratio even if such transfers do not constitute nontaxable gifts with respect to all trust beneficiaries. Thus, if a parent makes a transfer to trust in which a child has a life estate and a grandchild the remainder, the portion of the transfer qualifying as a nontaxable gift might not be taken into account in determining the inclusion ratio for distributions to the grandchild even though the portion of the transfer to the grandchild was not a nontaxable gift.

Explanation of Provision

Under the bill, only nontaxable gifts which are direct skips would have a zero inclusion ratio. Such gifts to a trust would not have an inclusion ratio of zero unless (1) no portion of the corpus or income of the trust could be distributed to a person other than the individual benefited by the gift, and (2) if the individual benefited dies before termination of the trust, the trust assets will be includible in his estate.

This provision applies to transfers after October 14, 1987.

17. Effective date of the revised generation-skipping transfer tax (sec. 114(h)(1) and (2) of the bill and sec. 1433 of the Reform Act)

Present Law

The revised generation-skipping transfer tax generally applies to transfers made after the date of enactment of the Reform Act (October 22, 1986). In addition, the revised generation-skipping transfer tax applied to inter vivos transfers made after September 25, 1985.

The generation-skipping transfer tax does not apply, however, to—

(1) inter vivos transfers made before September 26, 1985,

(2) trusts that were irrevocable before September 26, 1985, except for additions of corpus to such trusts after September 25, 1985,

(3) testamentary transfers made pursuant to wills in existence before the date of enactment of the Reform Act (October 22, 1986) if the decedent died before January 1, 1987, and

(4) transfers under a trust to the extent that such trust consists of property included in the gross estate of the decedent or which are direct skips which occur by reason of the death of any decedent if the decedent was incompetent on the date of enactment of the Reform Act (October 22, 1986) and at all times thereafter until death.

Explanation of Provision

The bill clarifies that the grandfather of irrevocable trusts created before September 25, 1985, applies whether or not income derived from corpus contributions before September 26, 1985, is distributed or accumulated. The bill also provides that the grandfather of transfers made pursuant to wills in existence on the date of enactment of the Reform Act (October 22, 1986) if the decedent dies before January 1, 1987, also applies to transfers pursuant to revocable trusts which were in existence on the date of enactment of the Reform Act (October 22, 1986) if the decedent dies before January 1, 1987.

18. $2 million exemption (sec. 114(h)(3) of the bill and sec. 1433 of the Reform Act)

Present Law

The revised generation-skipping transfer tax on direct skips does not apply to transfers before January 1, 1990, from a transferor to a grandchild of the transferor to the extent that the aggregate transfers from that transferor to that grandchild do not exceed $2 million. An election may be made to treat inter vivos and testamentary contingent transfers in trusts for the benefit of a grandchild as direct skips if (1) the transfers occur before the date of enactment of the Reform Act (October 22, 1986), and (2) the transfers would be direct skips except for the fact that the trust instrument provides that, if the grandchild dies before vesting of the interest transferred, the interest is transferred to the grandchild's heirs (rather than the grandchild's estate). Transfers treated as direct skips as a result of this election are subject to Federal gift and estate tax on the grandchild's death in the same manner as if the contingent gift over had been to the grandchild's estate.

Explanation of Provision

The bill clarifies the application of the $2 million exemption in three respects. First, the bill clarifies that a transfer to a trust is treated as a transfer to a grandchild if (1) no amount may be distributed to any person other than that grandchild during the life of that grandchild, (2) the assets will be includible in the gross estate of the grandchild if the grandchild dies before the termination of the trust, and (3) all of the income of the trust after the child has reached age 21 must be distributed to the grandchild not less often than annually. The third requirement applies only to transfers after June 10, 1987. It is intended that the third requirement would not be satisfied by a so-called *Crummey* power.

Second, the bill clarifies that trusts which are eligible for the $2 million exemption are treated as if that trust had been subject to the generation-skipping transfer tax and, consequently, that distributions out of a trust to such a grandchild are not treated as taxable distributions.

Third, the bill amends the special rules applicable to transfers in trust before the date of enactment of the Reform Act (sec. 1433(d) of that Act) by (a) clarifying that transfers to such trusts are treated as transfers to a grandchild (and, therefore, eligible for the $2 million exclusion) and (b) providing that the executor of the grandchild can recover the additional estate taxes imposed upon the estate of the grandchild by reason of the election from that person or persons receiving the property unless the will of the grandchild provides otherwise.

XV. COMPLIANCE AND TAX ADMINISTRATION PROVISIONS (SEC. 115 OF THE BILL)

1. Nominee reporting by partnerships (sec. 115(a) of the bill, sec. 1501 of the Reform Act, and sec. 6724(d)(2)(B) of the Code)

Present Law

Present law requires that any person holding an interest in a partnership as a nominee for another person must furnish to the partnership the name and address of that other person (along with any additional information required by regulations) (Code sec. 6031(c)). Failure by the nominee to provide this information to the partnership is not subject to the general penalty for failure to file information reports as required.

Explanation of Provision

The bill provides that a nominee's failure to supply the required information to the partnership is subject to the general penalty for failure to furnish payee statements (sec. 6722). This penalty is $50 per failure, up to a maximum of $100,000 per calendar year.

2. Negligence and fraud penalties (sec. 115(b) of the bill, sec. 1503 of the Reform Act, and secs. 6013(b)(5), 6601(e), and 6653 of the Code)

Present Law

Taxpayers are subject to penalties if any part of an underpayment of tax is due to negligence or fraud (Code sec. 6653). Both of these penalties have two components. The first component of each penalty is the basic penalty (5 percent of the entire underpayment in the case of negligence, 75 percent of the portion attributable to fraud in the case of fraud). The second component of each penalty is an amount equal to one-half the interest payable on the portion of the underpayment attributable to either negligence or fraud (as the case may be), for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax if that date is earlier). Interest on the negligence and fraud penalties generally begins on the date these penalties are assessed, rather than the last date prescribed for filing the return to which the penalty relates.

Explanation of Provision

The bill repeals the second, time-sensitive components of both the negligence and fraud penalties. The bill instead imposes interest on these penalties from the last date prescribed for filing the return to which the penalty relates. The bill also improves the coordination of these penalties with the provision permitting a couple to file a joint return after filing a separate return (Code sec. 6013(b)). These provisions apply to returns the due date for which (determined without regard to extensions) is after December 31, 1988.

The bill amends the negligence penalty for failure to include on a tax return amounts shown on an information return by reinstating the prior-law rule providing that the penalty is restricted to the portion of the underpayment of tax attributable to the failure to report.

3. Penalty for substantial understatement of tax liability (sec. 115(c) of the bill and sec. 1504 of the Reform Act)

Present Law

A taxpayer who substantially understates income tax for any taxable year must pay a penalty (Code sec. 6661). The Tax Reform Act of 1986 provided that this penalty is to be 20 percent of the amount of the underpayment of tax attributable to the understatement. This was effective for returns the due date of which (determined without regard to extensions) is after December 31, 1986.

After considering the Tax Reform Act of 1986, Congress considered the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509). That Act[1] increased this penalty to 25 percent of the underpayment, effective for penalties assessed after the date of enactment of that Act. Although Congress considered the Tax Reform Act of 1986 prior to considering the Omnibus Budget Reconciliation Act, the Omnibus Budget Reconciliation Act was enacted one day before the date of enactment of the Tax Reform Act of 1986.[2]

Explanation of Provision

The bill provides that the increase in the substantial understatement penalty to 25 percent made by the Omnibus Budget Reconciliation Act of 1986 shall take effect as if the Tax Reform Act of 1986 were enacted on the day before the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

4. Differential interest rate (sec. 115(d) of the bill, sec. 1511 of the Reform Act, and sec. 6621 of the Code)

Present Law

The interest rate that taxpayers pay to the Treasury on underpayments of tax is one percentage point higher than the interest rate that the Treasury pays to taxpayers on overpayments of tax.

Explanation of Provision

The bill corrects several cross-references to the provisions utilized to determine these rates.

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[1] *See* sec. 8002 of the Omnibus Budget Reconciliation Act of 1986.

[2] The Omnibus Budget Reconciliation Act of 1986 was enacted on October 21, 1986; the Tax Reform Act of 1986 was enacted on October 22, 1986.

5. Information reporting by brokers (sec. 115(e) of the bill, sec. 1521 of the Reform Act, and sec. 6045 of the Code)

Present Law

Persons doing business as a broker must report on specified types of transactions they effect for customers. Generally, reporting is required on sales of securities, commodities, regulated futures contracts, precious metals, and real estate.

Explanation of Provision

The bill provides that a person shall not be treated as a broker with respect to activities consisting of managing a farm on behalf of another person. This exempts farm managers from the requirement of filing a Form 1099-B with respect to their farm management activities. This information must be filed by these farm managers on a Schedule F, where it is provided in a more useful format. Consequently, filing this information on a Form 1099-B is duplicative. This provision is effective as if included in the Tax Equity and Fiscal Responsibility Act of 1982 (which generally imposed these information reporting requirements).

The bill provides that the person required to provide information returns on real estate transactions (who is generally defined as the person responsible for closing the real estate transaction) is to be called a "real estate reporting person" instead of a "real estate broker."

The bill also makes it unlawful for any real estate reporting person to charge separately any customer for complying with the information reporting requirements with respect to real estate transactions. This provision is effective on the date of enactment of the bill.

6. Information reporting on persons receiving contracts from certain Federal agencies (sec. 115(f) of the bill, sec. 1522 of the Reform Act, and sec. 6050M of the Code)

Present Law

Present law requires that the head of each Federal executive agency file an information return with the IRS indicating the name, address, and taxpayer identification number of each person with which the agency enters into a contract. The agency must also report any additional information required under Treasury regulations. There is no exception from this information reporting in present law for contracts involving national security, confidential law enforcement, or foreign counterintelligence activities.

Explanation of Provision

The bill excepts specified types of contracts from the general information reporting requirements applicable to Federal executive agencies, and subjects those types of contracts to a different form of information reporting.

There are two types of contracts between a Federal executive agency and another person that are subject to these special rules.

The first is a contract where either the fact of the existence of the contract or the subject matter of the contract has been classified. This is accomplished by designating and clearly marking or clearly representing, pursuant to the provisions of Federal law or an Executive order,[3] that the contract or the subject matter of the contract requires a specific degree of protection against unauthorized disclosure for reasons of national security. The second type of contract subject to the special rules is a contract involving a confidential law enforcement or foreign counterintelligence activity. In order to be eligible for these special rules, the head of the Federal executive agency (or his designee) must determine in writing that filing the information return generally required of Federal executive agencies would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity. This determination must be made pursuant to regulations issued by the Federal executive agency making the determination. This second type of contract involves primarily undercover operations (including sites for undercover operations) and informants.

These two types of contracts are subject to special information reporting requirements, and are exempted from the general information reporting requirements of section 6050M. The special information reporting requirements are that the IRS must first request that the Federal executive agency acknowledge whether that agency has entered into a contract with a particular person, who must be identified in the IRS request. The Federal executive agency must in response acknowledge whether it has entered into a contract with the specified person. If it has, it must provide to the IRS with respect to that person the information required to be reported under section 6050M. In addition, the agency must provide whatever additional information the agency and the Treasury agree is appropriate. The term "person" has the meaning given in section 7701(a)(1).

It is contemplated that the information provided by Federal executive agencies to the IRS under these special rules might need to be provided only to certain IRS employees, such as those with security clearances. If this is necessary, it is also contemplated that the Federal executive agencies will cooperate with the IRS in expeditiously obtaining clearance for the IRS employees.

This provision is effective as if included in the 1986 Act (i.e., on January 1, 1987).

7. Information reporting on royalties (sec. 115(g) of the bill, sec. 1523 of the Reform Act, and sec. 6676 of the Code)

Present Law

Persons who make payments of royalties aggregating $10 or more to any person in a calendar year must provide an information report on the royalty payments to the IRS (as well as provide a copy to the payee) (Code sec. 6050N).

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[3] Executive Order 12356 is the currently effective Executive order prescribing a uniform system for classifying, declassifying, and safeguarding national security information (47 Federal Register 14874; April 6, 1982).

Explanation of Provision

The bill deletes the requirement that payors of royalties must exercise due diligence in obtaining the taxpayer identification numbers of payees of royalties.

This requirement is eliminated because of its interaction with the requirements of backup withholding (Code sec. 3406). Prior to the bill, a payor of royalties was required to exercise due diligence in obtaining a taxpayer identification number; otherwise the payor was subject to a penalty for failure to exercise due diligence. This was parallel to the treatment of payors of interest and dividends. Payors of interest and dividends are required to impose backup withholding if the payee does not certify that the taxpayer identification number is correct. Unlike payors of interest and dividends, payors of royalties were not permitted to impose backup withholding under these circumstances. The requirement that payors of royalties exercise due diligence in obtaining taxpayer identification numbers is consequently repealed to eliminate this nonparallel treatment of royalties. After repeal, payors of royalties are treated similarly to payors of other reportable payments subject to backup withholding (other than interest and dividend payors).

8. Estimated tax requirements for tax-exempt organizations (sec. 115(h) of the bill, sec. 1542 of the Reform Act, and sec. 6154 of the Code)

Present Law

Present law, as amended by the 1986 Act, requires that estimated tax payments of the excise tax on the net investment income of private foundations and the tax on unrelated business income of tax-exempt organizations be made in accordance with the rules generally applicable to corporate estimated tax payments.

Explanation of Provision

The bill clarifies that the corporate estimated tax provisions apply to all payments of estimated tax by private foundations.[4] These provisions apply whether the private foundation is organized as a trust or as a corporation, and whether or not the foundation is tax-exempt. Thus, for example, a taxable private foundation organized as a trust will be required to make estimated tax payments of both the excise tax under section 4940(b) and any income tax under subtitle A in accordance with the rules of sections 6154 and 6655. The individual estimated tax provisions will not apply to any private foundation or tax-exempt trust.

The bill further provides that in the case of a tax-exempt organization or a private foundation, the period of underpayment of estimated tax runs to the 15th day of the fifth month following the close of the taxable year (i.e., the due date of the unrelated business income tax return).

The bill also provides one additional month for the computation of estimated taxes required to be paid by these tax-exempt organizations, as well as by trusts and estates. This is done by amending the annualization rule for these entities so that each payment is computed for a period one month shorter than under present law. Thus, these entities will generally have 45 days (instead of 15 days) to compute their estimated tax payments under the annualization rule. The dates the estimated tax payments are due are not altered.[5]

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[4] For taxable years beginning after December 31, 1987, the identical provision was adopted by section 10301 of the Revenue Act of 1987. See section 6655(g)(3) of the Code.

9. Awards of attorney's fees in tax cases (sec. 115(i) of the bill, sec. 1551 of the Reform Act, and sec. 7430(c)(2)(A) of the Code)

Present Law

The prevailing party (other than the United States) in tax cases may be eligible for an award of attorney's fees if it can establish that the position of the United States was not substantially justified and if other conditions are satisfied, which are generally parallel to the requirements for an award of attorney's fees under the Equal Access to Justice Act (which generally applies in non-tax cases).

Explanation of Provision

The bill clarifies two cross-references to provisions of the Equal Access to Justice Act. First, the bill clarifies that the rules of that Act relating to the time period within which a claim for attorney's fees must be made also apply to claims in tax cases. Second, the bill clarifies that the net worth limitations of that Act (rather than parallel provisions elsewhere in the United States Code) apply to prevailing parties in tax cases.

10. Salary of special trial judges (sec. 115(j) of the bill and sec. 1556 of the Reform Act)

Present Law

The salary of special trial judges of the Tax Court is 90 percent of the salary of judges of the Tax Court (Code sec. 7443A(d)(1)). The President's salary recommendations[6] may be construed to have reduced the salary of special trial judges below that 90-percent level.

Explanation of Provision

The bill provides that to the extent the President's salary recommendations are inconsistent with the 90-percent level specified in the Code, the recommendations are not effective.

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[5] Sec. 204(n) of the bill makes an identical amendment to section 6655(g)(3) of the Code, as revised by the Revenue Act of 1987.

[6] *The Budget of the United States Government, 1988, Recommendations for Executive, Legislative, and Judicial Salaries*, submitted to the Congress on January 5, 1987.

11. Retirement pay of Tax Court judges (sec. 115(k) of the bill, sec. 1557 of the Reform Act, and sec. 7447 of the Code)

Present Law

A Tax Court judge's retirement pay is based upon the judge's length of service as a judge. A judge who serves on the Tax Court at least 10 years receives full retirement pay; the retirement pay of a judge serving less than 10 years is proportionately reduced. Time served as a judge in recalled status after retirement does not count for purposes of computing the 10-year period.

Explanation of Provision

The bill provides that service on a substantially full-time basis in recalled status after retirement is considered in computing the 10-year period. The provision applies for purposes of determining retirement pay paid after the date of enactment of the bill, regardless of when the services in recalled status after retirement were or are performed.

12. Suspension of statute of limitations during prolonged dispute over third-party records (sec. 115(l) of the bill, sec. 1561 of the Reform Act, and sec. 7609 of the Code)

Present Law

If a dispute between a third-party recordkeeper and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is suspended until the issue is resolved (sec. 7609(e)).

Explanation of Provision

The bill clarifies that this suspension of the statute of limitations encompasses disputes with all third-party recordkeepers listed in the statute, regardless of whether the summons does or does not identify the person with respect to whose liability the summons is issued.

13. Rescission of statutory notice of deficiency (sec. 115(m) of the bill, sec. 1562 of the Reform Act, and sec. 6212 of the Code)

Present Law

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed.

Explanation of Provision

The bill clarifies that rescission of a statutory notice of deficiency does not affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding. For example, assume that six months remain to run on the statute of limitations with respect to a return when the IRS issues a statutory notice of deficiency. Issuance of this notice suspends the statute of limitations. If the IRS and the taxpayer agree to rescind the statutory notice, then as of the date the notice is rescinded, the statute of limitations again begins to run and (in this example) six months remains until the statute expires.

14. Abatements of interest due to error or delay (sec. 115(n) of the bill, sec. 1563 of the Reform Act, and sec. 6404(e)(1) of the Code)

Present Law

The IRS may, under specified conditions, abate interest that is attributable to error or delay by the IRS.

Explanation of Provision

The bill adds "error" as a condition justifying abatement to one reference where it was inadvertently omitted.

15. Exemption from levy for service-connected disability payments (sec. 115(o) of the bill and sec. 6334 of the Code)

Present Law

Under present law, various payments, such as unemployment benefits, workers' compensation, an amount of specified ordinary wages, as well as certain pensions and annuities, are exempt from levy. Thus, the IRS cannot seize these payments to collect delinquent taxes by serving a levy on the payment source. The IRS can collect the delinquent taxes from other nonexempt sources available to the delinquent taxpayer.

Certain service-connected disability benefits are included among those payments which are exempt from levy under section 6334. The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the active military, naval, or air service. This exemption covers direct compensation payments, as well as other types of support payments for education and housing.

The service-connected disability payments that presently are exempt from IRS levy include the following veterans' benefits described in Title 38, United States Code: wartime or peacetime or general compensation (subchapters II, IV, and VI of chapter 11 of title 38); certain life insurance payments (subchapters I, II, and III of chapter 19); specially adapted housing grants (chapter 21); vocational rehabilitation benefits (chapter 31); post-Vietnam era veterans' educational assistance (chapter 34); survivors' and dependents' educational assistance (chapter 35); housing and small business loans (chapter 37); and automobiles and adaptive equipment for certain disabled veterans (chapter 39).

Explanation of Provision

The bill adds the following service-connected disability benefits to those payments which, pursuant to section 6334, are exempt from levy by the IRS: compensation for wartime and peacetime death (provided for in subchapters III and V of chapter 11 of title 38, United States Code); dependency and indemnity compensation for service-connected deaths (provided for in chapter 13 of title 38, United States Code); and certain burial benefits (provided for in chapter 23 of title 38, United States Code). The bill revokes the present-law exemption from IRS levy for certain life insurance payments (provided for by chapter 19 of title 38, United States Code). This provision is effective for levies made after December 31, 1988.

16. Modification of withholding schedules (sec. 115(p) of the bill and sec. 1581(c) of the Reform Act)

Present Law

If an employee did not file a revised Form W-4 before October 1, 1987, the employer must withhold income taxes as if the employee claimed one allowance (if the employee checked the "Single" box on the most recent Form W-4 that the employee filed) or two allowances (if the employee checked the "Married" box).

Explanation of Provision

The bill provides that this rule would not apply if it would result in an increase in the number of withholding allowances for an employee. This is consistent with IRS instructions to employers.

17. General requirement of return, statement, or list (sec. 115(q) of the bill and sec. 6011 of the Code)

Present Law

When required by regulations, any person liable for any tax or the collection thereof must make a return or statement in the manner required.

Explanation of Provision

The bill clarifies the language of the Code containing this requirement.

18. Certain refundable credits to be assessed under deficiency procedures (sec. 115(r) of the bill and sec. 6211 of the Code)

Present Law

Under present law, the deficiency procedures allowing taxpayers to litigate issues in the Tax Court relating to the earned income credit (sec. 32) and the credit for the certain payments of the gasoline and special fuels tax (sec. 34) may not apply.

Explanation of Provision

The bill provides that the Tax Court deficiency procedures apply to the credits allowable under sections 32 and 34, notwithstanding that the credits reduce the net tax to less than zero.

The provision applies to notices of deficiencies mailed after the date of enactment of this bill.

XVI. EXEMPT AND NONPROFIT ORGANIZATIONS (SEC. 116 OF THE BILL)

1. Title-holding companies (sec. 116(a) of the bill, secs. 1603 and 1878(e) of the Reform Act, and secs. 501(c)(25) and 514(c)(9) of the Code)

Present Law

In general

The Reform Act provided a new category of tax-exempt organizations, consisting of certain corporations or trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income (less expenses) from such property to one or more specified categories of tax-exempt organizations that are shareholders of the corporation or beneficiaries of the trust (Code sec. 501(c)(25)). Such a title-holding company is entitled to tax-exempt status only if it has no more than 35 shareholders or beneficiaries and has only one class of stock or beneficial interest, and only if it meets certain other requirements.

Eligible shareholders or beneficiaries

Under the Reform Act, the categories of tax-exempt organizations eligible to hold interests in a section 501(c)(25) title-holding company are (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a governmental pension plan (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3); and (5) other title-holding companies described in section 501(c)(25).

Rights of eligible shareholders or beneficiaries

To qualify under section 501(c)(25), the title-holding company is required to permit its shareholders or beneficiaries to (1) dismiss, after reasonable notice, the corporation's or trust's investment advisor by majority vote of the shareholders or beneficiaries; and (2) terminate their interest by (a) selling or exchanging their stock or beneficial interest (subject to Federal or state securities law) to any other eligible organization, as long as the sale or exchange does not increase the total number of shareholders or beneficiaries to more than 35, or (b) redeeming their stock or beneficial interest after providing 90 days' notice to the corporation or trust. The Reform Act did not expressly provide a sanction for the failure of a title-holding company to satisfy the requirements relating to the rights of eligible shareholders or beneficiaries.

Unrelated business taxable income

Exempt organizations are subject to tax on any unrelated business taxable income, including income from debt-financed property. The term "debt-financed property" means any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)).

Under an exception to the debt-financed property rules, indebtedness incurred by certain tax-exempt organizations (i.e., qualified pension plans and certain tax-exempt educational organizations) as a result of the acquisition or improvement of real property is not considered acquisition indebtedness (sec. 514(c)(9)). The Reform Act extended this exception to debt-financed real property held by a section 501(c)(25) title-holding company.

The Reform Act also provides that an interest in a mortgage is not treated as an interest in real property for purposes of the debt-financed property rules in the case of real property held by a partnership (sec. 514(c)(9)(B)(vi)).

Explanation of Provision

Definition of real property

The bill clarifies the definition of permissible holdings of real property by a title-holding company by providing that, for purposes of section 501(c)(25), the term "real property" does not include any interest as a tenant in common (or similar interest) and does not include any indirect interest. This rule ensures a consistent application of the intent of section 501(c)(25) that a title-holding company is required to hold real property directly and cannot, for example, treat an interest in a partnership, trust, or other entity as an investment in real property.

The bill also provides that, for purposes of section 501(c)(25), the term "real property" includes any personal property that is leased under, or in connection with, a lease of real property. This exception to the general rule that a section 501(c)(25) title-holding company may only hold real property applies only if the rent attributable to the leasing of such personal property (determined under the rules of sec. 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property under the lease.

Eligible shareholders or beneficiaries

In order to implement the 35-person limitation on shareholders or beneficiaries of a section 501(c)(25) organization, the bill deletes the provision of the Act that had defined an eligible shareholder or beneficiary in a title-holding company to include other section 501(c)(25) title-holding companies. In lieu of that rule, the bill provides that a corporation that is a qualified subsidiary of a section 501(c)(25) title-holding company is not to be treated as a separate corporation for Federal tax law purposes. In the case of such a qualified subsidiary, all assets, liabilities, and items of income, deduction, and credit of the qualified subsidiary are treated as assets, liabilities, and such items of the title-holding company.

Under the bill, the term "qualified subsidiary" means a corporation that, at all times while in existence, is wholly owned by the section 501(c)(25) title-holding company. If a qualified subsidiary subsequently ceases to satisfy the 100-percent stock ownership requirement, the qualified subsidiary is treated, immediately before the time it ceases to meet such ownership requirement, as a new corporation acquiring all of its assets and assuming all of its liabilities in exchange for its stock.

Rights of shareholders or beneficiaries

The bill expressly provides that a title-holding company is not entitled to tax-exempt status under section 501(c)(25) if it fails to permit its shareholders or beneficiaries to dismiss the organization's investment advisor or to terminate their interest in the corporation or trust in the manner specified in the statute.

Unrelated business taxable income

The bill modifies the exception to the unrelated business taxable income rules in the case of debt-financed real property owned by a section 501(c)(25) title-holding company to provide that the exception is not available in the case of a disqualified holder. (A title-holding company does not fail to qualify for tax-exempt status merely because its shareholders or beneficiaries have unrelated business income as a result of the operation of this rule.)

Thus, in computing the unrelated business taxable income of a disqualified holder of an interest in a title-holding company, the holder's pro rata share of the items of income that are treated as gross income derived from an unrelated trade or business (without regard to the exception for debt-financed real property) is taken into account as gross income of the disqualified holder derived from an unrelated trade or business. Further, the holder's pro rata share of the items of deductions allowable in computing unrelated business taxable income (without regard to the exception for debt-financed real property) also is taken into account as deductions in computing unrelated business taxable income. These items of income and deduction are taken into account for the taxable year of the holder in which (or with which) the taxable year of the title-holding company ends.

Under the bill, the term "disqualified holder" means any title-holding company shareholder or beneficiary other than either (1) an educational institution (described in sec. 170(b)(1)(A)(ii)) or its affiliated support organizations (described in sec. 509(a)(3)) or (2) a qualified pension trust (within the meaning of sec. 401(a)).

Under the bill, the rule excluding an interest in a mortgage from the definition of real property applies for all purposes under the exception for debt-financed real property, rather than solely in the case of real property held by a partnership.

XVII. MISCELLANEOUS PROVISIONS (SEC. 118 OF THE BILL) [1]

1. Tax-exempt entity leasing; definition of tax-exempt controlled entity (sec. 118(b)(2) of the bill, sec. 1802(a)(2) of the Reform Act, and sec. 168(h) of the Code)

Present Law

Under the Reform Act, the term "tax-exempt controlled entity" does not include a corporation more than 50 percent of the stock in which is owned by a foreign person or entity. In addition, in the case of a corporation the stock of which is publicly traded, a tax-exempt entity's holdings are disregarded unless such entity owns at least five percent of the stock in the corporation (sec. 168(h)(6)(F)(iii)).

Explanation of Provision

The bill clarifies that the amendment applies as if enacted in the Tax Reform Act of 1984.

2. Accrual of interest on certain short-term obligations (sec. 118(c) of the bill, sec. 1803(a)(8) of the Reform Act, and sec. 1281 of the Code)

Present Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for a taxable year that portion of the acquisition discount or original issue discount on a short-term obligation that is allocable to the portion of the year during which the taxpayer held the obligation. The 1986 Act clarified that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest, irrespective of whether the interest is stated or is in the form of discount. The amendment made by the Act applies to obligations acquired after September 27, 1985.

Explanation of Provision

The bill provides that the amendment made by the 1986 Act applies only to obligations acquired after December 31, 1985. The purpose of the change in effective date is to relieve taxpayers of administrative burdens on short-term obligations acquired after September 27, 1985 and before January 1, 1986.

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[1] **Note**: Section 117 of the bill contains clerical and conforming changes only.

3. Application of market discount rules in case of partial principal payments (sec. 118(c)(2) of the bill, sec. 1803 of the Act, and secs. 1276 and 1278 of the Code)

Present Law

The 1984 Act provided that any partial principal payment on a market discount bond is includible in gross income to the extent that such payment does not exceed the accrued market discount on such bond.

Market discount is the excess of the stated redemption price of the bond at maturity over the basis of such bond immediately after its acquisition by the taxpayer. In the case of a bond having original issue discount, the stated redemption price at maturity is treated as equal to its revised issue price. Revised issue price is the sum of the issue price of the bond and the aggregate amount of the original issue includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer. Neither stated redemption price at maturity nor revised issue price are adjusted for partial principal payments prior to the acquisition of the bond.

Explanation of Provision

The bill clarifies that the Treasury is authorized to issue regulations providing proper adjustment in the case of a bond the principal of which may be paid in two or more payments.

4. Earnings and profits (sec. 118(d)(4) of the bill, sec. 1804 of the Reform Act, and sec. 312(b) of the Code)

Present Law

The Act clarified the effect on earnings and profits of a distribution of appreciated property.

Explanation of Provision

The bill provides that the rules relating to the distribution of appreciated property under section 312(b) do not apply to a distribution of a corporation's own obligation. Thus, earnings and profits will not be increased by reason of such a distribution.

5. Treatment of transferor corporation (sec. 118(d)(5) of the bill, sec. 1804 of the Reform Act, and secs. 361 and 355 of the Code)

Present Law

The Tax Reform Act of 1984 generally required that all property received by a corporation in a "C" reorganization be distributed. In addition, that Act provided that a corporation must recognize gain on the distribution of appreciated property to its shareholders in a nonliquidating distribution. The 1986 Act made a series of amendments to the reorganization provisions attempting to conform those provisions with changes made by the 1984 Act. However, numerous technical problems with the 1986 amendments have arisen. The bill responds to these technical problems with a complete revision of the 1986 amendments.

Explanation of Provision

Treatment of reorganization exchange.— The bill restores the provisions of section 361, relating to the nonrecognition treatment of an exchange pursuant to a plan of reorganization, as in effect prior to the amendments made by the 1986 Act. Thus, as under prior law, gain or loss will generally not be recognized to a corporation which exchanges property, in pursuance of the plan of reorganization, for stock and securities in another corporation a party to the reorganization. However, as under prior law, gain will be recognized to the extent the corporation receives property other than such stock or securities and does not distribute such other property pursuant to the plan of reorganization.[2]

The bill amends prior law by providing that transfers of property to creditors in satisfaction of the corporation's indebtedness in connection with the reorganization are treated as distributions pursuant to the plan of reorganization for this purpose.[3] The Secretary of the Treasury may prescribe regulations necessary to prevent tax avoidance by reason of this provision. This amendment is not intended to change in any way the definition of a reorganization within the meaning of section 368.

Treatment of distributions in reorganizations.—The bill also conforms the treatment of distributions of property by a corporation to its shareholders in pursuance of a plan of reorganization to the treatment of nonliquidating distributions (under section 311). Under the bill, the distributing corporation generally will recognize gain, but not loss, on the distribution of property in pursuance of the plan of reorganization. However, no gain will be recognized on the distribution of "qualified property". For this purpose, "qualified property" means (1) stock (or rights to acquire stock) in, or the obligation of, the distributing corporation and (2) stock (or rights to acquire stock) in, or the obligation of, another corporation which is a party to the reorganization and which were received by the distributing corporation in the exchange.[4] The bill also provides that the transfer of qualified property by a corporation to its creditors in satisfaction of indebtedness is treated as a distribution pursuant to the plan of reorganization.[5]

Basis.—The bill clarifies that the basis of property received in an exchange to which section 361 applies, other than stock or securities in another corporation a party to the reorganization, is the fair market value of the property at the time of the transaction (pursuant to section 358(a)(2)). Thus the distributing corporation will recognize only post-acquisition gain on any taxable disposition of such property received pursuant to the plan of reorganization. Of course, the other corporation will recognize gain or loss on the transfer of its property under the usual tax principles governing the recognition of gain or loss.

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[2] This could occur, for example, where liabilities are assumed in a transaction to which section 357(b) or (c) applies.

[3] This overrules the holding in *Minnesota Tea Company v. Helvering*, 302 U.S. 609 (1938).

[4] For analysis that acquiring corporation voting stock held by the acquired corporation in a Type C reorganization is transferred to the acquiring corporation in exchange for the same stock, see Rev. Rul. 78-47, 1978-1 C.B. 113.

[5] These amendments are not intended to affect the treatment of any income from the discharge of indebtedness arising in connection with a corporate reorganization.

Treatment of section 355 distributions.—Finally, the bill provides that the rules of section 311 shall apply to the distribution of property in a section 355 transaction which is not in pursuance to a plan of reorganization. Thus, gain (but not loss) will be recognized on the distribution of property other than the stock or securities in the controlled corporation in a transfer to which section 355 (or so much of section 356 as relates to section 355) applies. For this purpose, the gain recognition provisions of section 311(b) will not apply to the distribution of securities notwithstanding that the recipient may be taxed by reason of the excess principal amount rule of section 355(a)(3)(A), but the gain recognition rule will apply to stock which is not permitted to be received tax-free under section 355(a).

6. Golden parachutes (sec. 118(d)(6)-(8) of the bill, sec. 1804(j) of the Reform Act, and sec. 280G of the Code)

Present Law

Under present law, no deduction is allowed for "excess parachute payments" (sec. 280G) and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment (sec. 4999).

The term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual (1) with respect to a corporation that was, immediately before the change in control, a small business corporation (as defined in sec. 1361(b), relating to S corporations) or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on an established securities market, or otherwise, provided shareholder approval was obtained with respect to the payment to a disqualified individual.

The Secretary may, by regulations, provide that a corporation fails to meet the requirement that it have no stock that is readily tradable if a substantial portion of the assets of any entity consists (either directly or indirectly) of stock in the corporation and interests in the entity are readily tradable on an established securities market, or otherwise.

Congress was concerned that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisons by creating tiers of entities. Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of such entity's assets. Congress contemplated that, in such cases, the Secretary will adopt regulations requiring approval of the owners of the entity rather than the approval of the entity itself. Of course, such shareholder approval may be obtained only if the entity shareholder also has no stock that is readily tradable.

The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the golden parachute provisions.

Explanation of Provision

Under present law, a corporation could fail to qualify for the shareholder approval exception if it has nonvoting preferred stock that is publicly traded, even if all common stock of the corporation is not publicly traded. In some cases, an interest in preferred stock is more in the nature of debt than equity. The purpose of the golden parachute provisions is to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals. No protection is necessary in the case of nonvoting preferred stock if the preferred shareholders receive the redemption or liquidation value to which they are entitled.

Thus, the bill provides that, for purposes of the shareholder approval requirements, the term "stock" does not include any stock (1) that is not entitled to vote, (2) that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) that has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), (4) that is not convertible into another class of stock, and (5) the rights of which are not adversely affected by the parachute payments.

The bill addresses several issues that arise in the application of the shareholder approval requirements for a corporation the stock of which is not publicly traded by expanding the Secretary's regulatory authority under the golden parachute provisions. It is expected that regulations will address these issues, particularly the application of the shareholder approval requirements in the case of shareholders that are not individuals (i.e., the shareholders are partnerships, corporations, or other nonindividual entities), and to what extent nonvoting interests in the entity shareholder have the right to affect the approval of that shareholder. In general, it is anticipated that the normal voting rights of the entity shareholder will determine whether or not the entity shareholder approves the parachute payments. For example, limited partners with no right to vote on partnership issues generally would not be entitled to vote with respect to the partnership shareholder's approval of a parachute payment.

The bill specifically authorizes the Secretary to prescribe regulations addressing the application of the shareholder approval requirements to entity shareholders that hold de minimis amounts of stock in the corporation. Of course, shareholder approval would still be required if the corporation constituted a substantial portion of the assets of the entity shareholder.

For purposes of the small business exception, the bill provides that "small business corporation" is defined as in section 1361(b) but without regard to paragraph (1)(C) thereof (relating to nonresident aliens). In the golden parachute context, the effect of the use of the small business corporation definition was to treat domestic corporations less favorably to the extent they were owned by foreign persons rather than U.S. persons. Because less favorable treatment was accorded to these corporations solely because they were owned by foreign persons (as contrasted to U.S. corporations whose shareholders were not taxable by the United States), this golden parachute provision discriminated against foreign persons and would have violated certain U.S. treaties.

7. Consolidation of former DISCs (sec. 118(d)(10) of the bill, sec. 1804(e)(10) of the Reform Act, and sec. 1504 of the Code)

Present Law

The Deficit Reduction Act of 1984 modified the rules applicable to Domestic International Sales Corporations (DISCs). The 1984 Act forgave the tax on post-1984 distributions of accumulated DISC income by treating such income as previously taxed income. This exemption did not apply to the deemed distributions resulting from a termination of a DISC, unless the termination resulted solely from the changes made by the Act. The 1984 Act also required existing fiscal-year DISCs to close their taxable year on December 31, 1984. In certain cases, the shareholder of the DISC was permitted to include income of the DISC that otherwise would have been deemed distributed in the resulting short period over a period of up to ten years.

The 1986 Act amended the affiliation rules of section 1504 to make a former DISC which has no accumulated DISC income derived after December 31, 1984, an includible corporation. Accordingly, such a corporation must be included in the consolidated return of a parent corporation meeting the 80-percent ownership requirements of section 1504. The purpose of this amendment was to prevent a tax-motivated deconsolidation of a subsidiary through a contribution of its stock to a former DISC of the parent.

Explanation of Provision

Under the bill, only a corporation that is a DISC for the current taxable year is excluded from the term "includible corporation" for purposes of the affiliation rules. Thus, a corporation that formerly was a DISC that otherwise meets the affiliation requirements of section 1504 must be included in a consolidated return filed by its parent corporation. However, a former DISC (or other corporation) will not be treated as a member of an affiliated group for purposes of determining the taxation of any distribution or deemed distribution of accumulated DISC income, unless the income is treated as previously taxed income pursuant to the 1984 Act. Thus, the shareholder-level tax on accumulated DISC income which Congress did not exempt from tax may not be avoided through a consolidated return dividend.[6]

In addition, a former DISC (or other corporation) will not be treated as a member of the consolidated group for purposes of determining the treatment of a deemed distribution of income from a 1984 short taxable year which the 1984 Act permitted to be included over a period of up to ten years.

It is expected that the consolidated return regulations will be modified to prevent a decrease in a parent corporation's basis in the stock of a subsidiary that formerly was a DISC for any distribution (or constructive distribution) of earnings representing previously taxed income. For example, assume a former DISC whose accumulated DISC income was treated as previously taxed income under the 1984 Act distributed that income to its parent in a post-1984 consolidated return year. Notwithstanding section 1.1502-32(b)(2)(iii)(*c*) of the Treasury Regulations, the parent's basis in the stock of the former DISC would not be reduced by the amount of the distribution and, correspondingly, the parent's earnings and profits account would not reflect a reduction (pursuant to section Treas. Reg. sec. 1.1502-33(c)(4)(ii)(*a*)) in that amount. *Cf.* Treas. Reg. sec. 1.1502-32(b)(7).

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[6] The effect of the bill is to prevent the distribution (or deemed distribution) to the parent corporation from being eliminated under the consolidated return rules. As a distribution from a former DISC, the distribution also would not be eligible for the dividends received deduction.

8. Treatment of multiple trusts for taxable years beginning after March 1, 1984 (sec. 118(e) of the bill, sec. 1806(a) of the Reform Act and sec. 643 of the Code)

Present Law

The 1984 Act provides that under Treasury regulations, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax.

The 1984 Act makes this provision effective for taxable years beginning after March 1, 1984. The 1986 Act provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

Explanation of Provision

The bill provides that if two or more trusts were treated as a single trust on a return for the first taxable year of the trusts beginning after March 1, 1984, and they would have been required to be so treated but for the amendment made by the 1986 Act, then such trusts will be treated as one trust for purposes of that taxable year. This provision applies only to trusts which did not accumulate any income or make any accumulation distributions during that year.

9. Settlement funds (sec. 118(f) of the bill, sec. 1807(a)(7) of the Reform Act, and sec. 468B of the Code)

Present Law

A taxpayer generally may deduct qualified payments to a designated settlement fund at the time such payments are made. A qualified payment does not include any amount which may be transferred from a designated settlement fund to the taxpayer. The taxpayer may not hold a beneficial interest in the income or corpus of the fund.

Under the Act, the income earned on amounts transferred to an escrow account, settlement fund, or other similar fund is subject to current tax notwithstanding any other provision of law. The Act also provides that if the amount transferred to an account or fund is not deductible, then the account or fund is taxed as a grantor trust.

Explanation of Provision

The bill clarifies that a qualified payment does not include any amount which may be transferred from a designated settlement fund to any person related to the taxpayer.

The bill also clarifies that a designated settlement fund (1) must extinguish completely the taxpayer's tort liability with respect to a class of claimants, and (2) must not under its terms provide a beneficial interest in the income or corpus of the fund to any person related to the taxpayer.

The bill incorporates as part of the Code the provision of the Act relating to the current taxation of the income earned on amounts transferred to an escrow account, settlement fund, or other similar fund. The bill also authorizes the Secretary of the Treasury to prescribe regulations that identify the person that is subject to current tax on the income from such an account or fund.

It is anticipated that these regulations will provide that if the amount is transferred pursuant to an arrangement that constitutes a trust, then the income earned by the amounts transferred will be currently taxed under Subchapter J of the Code. Thus, for example, if the transferor retains a reversionary interest in any portion of the trust that exceeds 5 percent of the value of that portion, or the income of the trust may be paid to the transferor, or may be used to discharge a legal obligation of the transferor, then the income is currently taxable to the transferor under the grantor trust rules.

10. Transfers of incentive stock options incident to divorce, etc. (sec. 118(k) of the bill, sec. 1842 of the Reform Act, and sec. 425(c) of the Code)

Present Law

The 1984 Act provided that transfers of property between spouses or incident to divorce were non-taxable carry-over basis transactions.

Explanation of Provision

The bill clarifies that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax-free.

11. Treatment of stripped tax-exempt bonds (sec. 118(p)(4) of the bill, sec. 1879 of the Reform Act, and sec. 1286(d) of the Code)

Present Law

In determining the basis of a stripped coupon or stripped bond relating to a tax-exempt obligation under present law, the holder makes adjustments to basis to account for the accrual of original issue discount ("OID"). The total adjustment to basis on account of OID is an amount not in excess of that amount which produces a yield to maturity equal to the lower of (1) the coupon rate on the tax-exempt obligation, or (2) the yield to maturity of the stripped coupon or stripped bond.

Explanation of Provision

Under the bill, in the case of a tax-exempt obligation from which one or more coupons have been stripped, a portion of OID with respect to any stripped coupon or stripped bond (as determined under the general coupon stripping rules) is treated as OID on a tax-exempt obligation. OID in excess of the "tax-exempt portion" is treated as OID on an obligation that is not a tax-exempt obligation.

Under the bill, the tax-exempt portion of the OID with respect to a stripped coupon or stripped bond relating to a tax-exempt obligation is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield to maturity as of the purchase date (of the stripped coupon or stripped bond) equal to the lower of (1) the coupon rate on the tax-exempt obligation from which the coupons were separated, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or stripped bond. The taxpayer can elect to use the original yield to maturity instead of the coupon rate for these purposes.

For example, assume that a tax-exempt obligation with a face amount of $100 due January 1, 1990, and with a coupon rate of 10 percent (compounded semiannually) is issued for $100 on January 1, 1987, and is stripped on January 1, 1989. The right to receive the principal amount is sold for $79.21 reflecting a yield to maturity at the time of the strip of 12 percent (compounded semiannually). Under the bill, the tax-exempt portion of discount on the stripped bond is limited to $17.73, the difference between the stated redemption price ($100) and the issue price that would produce a yield to maturity of 10 percent ($82.27). This portion of the discount is treated as OID on a tax-exempt obligation.

The amount of discount on the stripped bond in excess of the tax-exempt portion is $3.06, equal to the excess of total discount ($20.79) over the tax-exempt portion. This portion of the discount is treated as OID with respect to an obligation that is not a tax-exempt obligation.

The total amount of OID allocable to the accrual period ending on July 1, 1989, with respect to the stripped-bond is $4.75 (6 percent of $79.21), of which $4.11 is treated as OID on a tax-exempt obligation (5 percent of $82.27) and $0.64 ($4.75 minus $4.11) is treated as OID on an obligation that is not a tax-exempt obligation. The holder's basis for the bond is increased to $83.96 ($79.21 issue price plus accrued discount of $4.75).

The provision is effective for any purchase or sale of a stripped coupon or stripped bond relating to a tax-exempt obligation after June 10, 1987. Present law remains in effect for any purchase or sale of any such stripped coupon or bond after October 21, 1986, and before June 11, 1987. Present law also remains in effect in the case of any person who, on June 10, 1987, held for sale in the ordinary course of such person's trade or business any obligation or coupon in stripped form, with respect to any sale of such obligation or coupon by such person, and with respect to any such obligation or coupon while held by another person who purchased such obligation from the person who held such obligation or coupon on June 10, 1987.

12. Reorganizations of investment companies (sec. 118(p)(5) of the bill, sec. 1879 of the Reform Act, and sec. 368 of the Code)

Present Law

The Act provided that stock of a RIC, REIT, or diversified investment company will not be treated as stock of a single issuer for purposes of determining whether the holder is diversified within the meaning of section 368(a)(2)(F)(ii). The legislative history of that amendment provided that the provision was intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more).

Explanation of Provision

The bill conforms the statutory language to the legislative history of the Act. The bill provides that, for purposes of determining whether a corporation is diversified, a person holding stock in a RIC, REIT, or diversified investment company shall, except as otherwise provided in regulations, be treated as holding its proportionate share of the assets held by the RIC, REIT, or diversified investment company. It is anticipated, for example, that the regulations may provide for exceptions in de minimis cases.

13. Treatment of payments from certain mining reclamation programs (sec. 118(p)(6) of the bill, and sec. 126 of the Code)

Present Law

Under present law, gross income does not include certain payments under environmental programs administered by the Agriculture Department or State programs for conservation purposes.

Explanation of Provision

The bill clarifies that payments under certain mining reclamation programs administered by the Interior Department or certain State conservation programs may qualify for this exclusion, and may qualify even though designated as for public health and safety purposes.

14. Elimination of duplicative Medicare tax provisions for certain State and local government employees (sec. 118(q) of the bill, sec. 1895 of the Reform Act, and sec. 3121(u) of the Code)

Present Law

Under present law, certain employees of State or local governments who are compensated solely on a fee basis are subject to the self-employment (SECA) tax, including the Medicare portion of that tax (sec. 1402(c)). The Consolidated Omnibus Budget Reconciliation

Act of 1985 (P.L. 99-272) extended Medicare coverage and tax to State and local government employees hired after 1985, effective for service performed after March 31, 1986 (sec. 3121(u)). No exception was provided for certain State and local government employees who were already subject to Medicare tax under section 1402(c).

Explanation of Provision

The bill provides an exception to the Medicare tax provision in section 3121(u) for individuals holding a position described in section 1402(c)(2)(E), effective for services performed after March 31, 1986.

15. Treatment of certain loans of artwork (sec. 118(r)(2) of the bill and sec. 2503 of the Code)

Present Law

A loan of a work of art to a public charity or a private operating foundation is treated as a transfer subject to Federal gift tax. Although constituting a gift, such a loan is not a deductible charitable contribution for Federal gift tax purposes.

Explanation of Provision

The bill provides that a loan of a qualified work of art to a public charity (or private operating foundation) for use in carrying on its charitable purpose shall not be treated as a transfer for Federal gift tax purposes. For other transfer tax purposes, the work shall be valued as if the loan had not been made. Thus, even if on loan at the time of the owner's death, the full value of the work of art is includible in the owner's estate. A qualified work of art is any archaeological, historic, or creative tangible personal property.

The provision is effective for transfers occurring after July 31, 1969.

TITLE II—TECHNICAL CORRECTIONS TO OTHER TAX LEGISLATION

A. Superfund Revenue Act of 1986 (Sec. 201 of the Bill)

1. Tax on chemical feedstocks (sec. 201(a) of the bill, sec. 513 of the Superfund Revenue Act, and sec. 4662 of the Code)

Present Law

Under present law, tax is imposed on the sale (by the manufacturer, producer, or importer) of 42 organic and inorganic chemical feedstocks. If the manufacturer, producer, or importer of a taxable chemical feedstock uses the feedstock, then tax is imposed on the use of the feedstock in the same manner as if the feedstock had been sold.

Under the "mixed stream" rule, no tax is imposed on the sale or use of any taxable organic chemical while such chemical is part of an intermediate hydrocarbon stream containing a mixture of taxable organic chemicals. Where tax is not imposed by reason of the mixed stream rule, the subsequent isolation, extraction, or removal of a taxable chemical from an intermediate hydrocarbon stream is treated as a taxable use.

A credit or refund (without interest) may be allowed or made to the taxpayer for tax paid with respect to a taxable chemical feedstock which is (1) exported, or (2) used to make a listed taxable substance which is exported. No credit or refund is allowed unless the person who paid the tax either has agreed to repay the tax to the exporter, or has obtained the written consent of the exporter waiving such repayment.

Explanation of Provisions

Refunds directly to exporter

Under the bill, the Secretary is required to issue regulations providing the conditions under which credit or refund (without interest) may be allowed or made to the exporter of a taxable chemical or listed taxable substance, rather than to the person who paid the tax, where the taxpayer waives his right to receive the refund and the exporter provides such information as may be required by the Secretary. Such conditions may include (1) a requirement that the exporter and the person who paid the tax register with the Internal Revenue Service, (2) a requirement that the exporter provide written evidence that the taxpayer has waived its right to the refund, and (3) the time, place, and manner in which claims for refund or credit are to be made.

Mixed stream rule

The bill clarifies that the present law treatment of intermediate hydrocarbon streams applies where the stream contains one taxable organic chemical feedstock and one or more nontaxable organic chemicals. Thus the mixed stream rule is not limited to mixtures containing two or more taxable organic chemical feedstocks. The term "intermediate hydrocarbon stream" generally means a mixture of organic chemicals which is subject to further distillation or processing in the manufacture of a taxable chemical.

2. Tax on certain imported substances (sec. 201(b) of the bill, sec. 515 of the Superfund Revenue Act, and sec. 4672 of the Code)

Present Law

A tax is imposed on any taxable substance sold or used by the importer thereof after 1988. The amount of tax generally is equal to the tax which would have been imposed by the chemical feedstock tax (sec. 4661) on the chemicals used as materials in the manufacture of a taxable substance had such chemicals been sold in the United States.

Taxable substances are those substances which are listed by the Secretary. A substance shall be listed if it is contained in the initial list of taxable substances (sec. 4672(a)(3)) or the Secretary determines that taxable chemicals constitute more than 50 percent of the weight (or, to the extent necessary to carry out the purposes of the tax, value) of the materials used to produce such substance (determined on the basis of the predominant method of production). The Secretary may add or remove substances from the list as necessary to carry out the purposes of the tax.

Explanation of Provision

The bill clarifies that the Secretary shall add any substance to the list which the Secretary determines meets either the weight or value test in present law; and may remove only those substances which the Secretary determines meet neither the weight nor the value test. An importer or exporter of a substance may petition the Secretary for a determination as to whether such substance meets the statutory requirement for listing. The Secretary must make a determination within 180 days of the filing of such petition. It is anticipated that the Secretary, pursuant to an appropriate petition, will list chemicals such as: polyethylene terephthalate, nylon 66, polyacrylonitrile, nylon 6, and ABS plastics and resins, which the Congressional Research Service has determined meet the statutory requirement for listing.

3. Broadbase environmental tax (sec. 201(c) of the bill, sec. 516 of the Superfund Revenue Act, and secs. 59A and 882 of the Code)

Present Law

Under present law, an environmental tax is imposed on corporations equal to 0.12 percent of the excess of modified alternative minimum taxable income ("AMTI") for the taxable year over $2 million. Modified AMTI means AMTI as defined for purposes of the corporate alternative minimum tax without regard to the alternative net operating loss and environmental tax deductions.

Although regulated investment corporations ("RICs") and real estate investment trusts ("REITs") are passive investment entities, they are classified as corporations and may have corporate alternative minimum taxable income.

Explanation of Provisions

RICs and REITs

The bill clarifies that the environmental tax does not apply to RICs and REITs.

Foreign corporations

The bill clarifies that a foreign corporation engaged in a trade or business within the United States is subject to the environmental tax on its income which is effectively connected with the conduct of a trade or business within the United States.

4. Leaking Underground Storage Tank Trust Fund excise tax (sec. 201(d) of the bill, sec. 521 of the Superfund Revenue Act, sec. 1703 of the Reform Act, sec. 10502 of the Revenue Act of 1987, and secs. 4041, 4081, 4091, 6416, 6421, and 6427 of the Code)

Present Law

Under present law, an additional 0.1 cent per gallon tax is imposed on gasoline, diesel, aviation, and special motor fuels otherwise subject to fuels excise taxes. This tax also is imposed on any liquid used, or sold for use, as a fuel in a diesel-powered train. Revenues from this tax are used to finance the Leaking Underground Storage Tank ("LUST") Trust Fund. The additional tax generally is imposed on the same tax base and is collected in the same manner as the other excise taxes on these fuels (Code secs. 4041, 4042, 4081, and 4091). The tax is not imposed on liquified petroleum gas.

The Tax Reform Act of 1986 allowed qualified retailers to elect to have the excise tax on diesel fuel for highway vehicles be imposed on the sale to the retailer by the wholesaler or producer, effective for sales after March 31, 1987. In addition, the 1986 Act generally required collection of the excise tax on gasoline at the time gasoline is removed from a refinery or a registered and bonded terminal, effective for gasoline removed after December 31, 1987. A floor stocks tax was imposed on all gasoline held for resale beyond the new point of collection on January 1, 1988.

The Revenue Act of 1987 made mandatory the collection by wholesale distributors (as opposed to retailers) of the excise tax (including the LUST tax) on diesel and non-gasoline aviation fuels, effective April 1, 1988. A floor stocks tax is imposed on all taxable fuels at the applicable rate (including the 0.1 cent LUST tax) held on April 1, 1988, by a retailer or bulk user who previously had not paid the tax. Amounts equivalent to the revenues raised by the LUST portion of the floor stocks tax are to be transferred to the LUST Trust Fund.

Explanation of Provisions

Tax on diesel fuel may be imposed on sale to retailer

The bill clarifies that prior to April 1, 1988, the 0.1 cent per gallon LUST tax on diesel fuel is imposed upon sale to a qualified retailer in situations where the tax on diesel fuel for highway vehicle use is imposed on such sale. (The Revenue Act of 1987 repealed this election effective April 1, 1988.)

Liquids used in aviation

The bill clarifies that prior to April 1, 1988, the 0.1 cent per gallon LUST tax applies to all liquids used, or sold for use, as fuel in an aircraft, but that the LUST tax is not to be imposed twice (i.e., by reason of both sections 4041 and 4081). (The Revenue Act of 1987 clarified this for sales and uses after March 31, 1988.)

The bill also clarifies that the additional tax imposed by section 4041(c) on gasoline used as a fuel in noncommercial aviation is computed without regard to the LUST tax, and thus is not reduced by the LUST tax.

Exempt sales

The bill clarifies that gasoline which is used as a fuel in an aircraft or in a train is not exempt from the LUST tax by reason of section 6421 (relating to off-highway business use and sales of gasoline for certain other exempt purposes).

Floor stocks tax

The bill clarifies that certain gasoline which on January 1, 1988 was held by a dealer is subject to a floor stocks tax at a rate of 9.1 cents rather than 9 cents per gallon.[1] This ensures that the 0.1 cent per gallon LUST tax is collected on such gasoline. The revenue attributable to the additional floor stock tax is to be transferred to the Leaking Underground Storage Tank Trust Fund. The bill further clarifies that the penalty and other provisions of law applicable to section 4081 taxes also apply to the floor stocks tax.

Gasoline and diesel fuel mixed with alcohol

The bill clarifies that the LUST financing rate is ⅑ cent per gallon in the case of: (1) the removal or sale of gasoline for use in a mixture consisting of at least 10 percent alcohol (effective with the 1986 Reform Act); and (2) the sale of diesel fuel for use in a mixture consisting of at least 10 percent alcohol (effective with the Revenue Act of 1987). These provisions ensure that imposition of LUST tax prior to mixture with alcohol does not result in a lower amount of tax liability than imposition of LUST tax on alcohol mixtures.[2]

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[1] An identical provision was contained in sec. 10251(d) of H.R. 3545 as reported by the House Committee on the Budget on October 26, 1987 and in sec. 6685(d) of the Revenue Bill of 1987 as reported by the Senate Finance Committee to the Senate Budget Committee on October 16, 1987. Notice 88-12 states that if the 0.1 cent floor stocks tax is not paid and the technical correction is enacted, payment of this tax will be required. *See*, Internal Revenue Bulletin 1988-6 (February 8, 1988) p. 13.

[2] Notice 88-12 states that the LUST tax rate on sales of gasoline for use in gasohol is ⅑ cent per gallon during the first quarter of 1988. *See*, Internal Revenue Bulletin 1988-6 (February 8, 1988) p. 13.

A conforming amendment ensures that where gasoline or diesel fuel is separated from a 10-percent alcohol mixture, the amount of tax imposed on the sale of such separated gasoline or diesel fuel shall be the generally applicable rate reduced by the tax previously imposed (and not credited or refunded).

The bill makes a conforming amendment with respect to the refund paid by the Secretary where gasoline or diesel fuel is subject to tax at the generally applicable rate and is subsequently used to produce a 10-percent alcohol mixture.

B. Harbor Maintenance Revenue Act of 1986 (Sec. 202 of the Bill)

1. Tax rate for fuel used on inland waterways (sec. 202(a) of the bill, sec. 1404(a) of the Harbor Maintenance Revenue Act, and sec. 4042(b) of the Code)

Present Law

The Superfund Revenue Act of 1986 (P.L. 99-499), as enacted on October 17, 1986, imposed an additional, separate "Leaking Underground Storage Tank Trust Fund financing rate" of 0.1 cent per gallon on fuel subject to the existing inland waterways fuel tax (Code sec. 4042). The Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), enacted on November 17, 1986, amended section 4042 to provide a gradual increase in the rate of waterways fuel tax, the revenues from which are transferred to the Inland Waterways Trust Fund. In restating the increased tax rates in section 4042(b), this subsequent amendment failed to include the 0.1 cent per gallon additional tax rate (for the Leaking Underground Storage Tank Trust Fund) that had been enacted the previous month.

Explanation of Provision

The bill provides that for purposes of Code section 4042 (inland waterways fuel tax), the amendment made by the Superfund Revenue Act of 1986 relating to the separate 0.1 cent per gallon tax for the Leaking Underground Storage Tank Trust Fund is to be treated as enacted after the amendment to section 4042 made by the Harbor Maintenance Revenue Act of 1986.

The bill therefore reinstates the separate 0.1 cent per gallon tax rate (in sec. 4042) for the Leaking Underground Storage Tank Trust Fund, as if included in the Harbor Maintenance Revenue Act of 1986. Thus, the additional 0.1 cent per gallon fuel tax is effective as of January 1, 1987, i.e., the effective date for such tax as enacted in the Superfund Revenue Act.

2. Exemption from the harbor maintenance tax for cargo transported between U.S. possessions, etc. (sec. 202(b) of the bill, sec. 1402(a) of the Harbor Maintenance Revenue Act, and sec. 4462(b) of the Code)

Present Law

A new harbor maintenance tax (Code secs. 4461-4462) was imposed under the Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), effective April 1, 1987. The tax is 0.04 percent of the value of commercial cargo loaded or unloaded at U.S. ports.

Under section 4462(b), the tax does not apply to (1) cargo loaded on a vessel in a U.S. mainland port for transportation to Alaska, Hawaii, or a U.S. possession for ultimate use or consumption therein; (2) cargo loaded on a vessel in Alaska, Hawaii, or a U.S. possession for transportation to the U.S. mainland for ultimate use or consumption therein; (3) unloading of such cargo (described in (1) or (2), above) in Alaska, Hawaii, or any U.S. possession or in the U.S. mainland, respectively; or (4) cargo loaded on a vessel in Alaska, Hawaii, or a U.S. possession and unloaded in the State or possession in which loaded. The exception does not apply to crude oil cargo with respect to Alaska.

Explanation of Provision

The bill provides a specific exemption in section 4462(b)(1)(B) for cargo transported between U.S. possessions, between U.S. possessions and Alaska or Hawaii, and between Alaska and Hawaii. The amendment is effective as if included in the Harbor Maintenance Act of 1986 (i.e., as of April 1, 1987).

3. Due date for study of impact of harbor maintenance tax on potential cargo diversion (sec. 202(c) of the bill and sec. 1407 of the Harbor Maintenance Revenue Act)

Present Law

Under the Harbor Maintenance Revenue Act of 1986, the Secretary of the Treasury (in consultation with the Secretaries of the Army and Transportation, the U.S. Trade Representative, and other appropriate Federal agencies) is to conduct a study to determine the impact of the harbor maintenance tax (0.04 percent of the value of the commercial cargo) on potential diversions of cargo to Canada or Mexico from U.S. ports. The report is due to the Congress by November 17, 1987 (one year after the date of enactment).

Explanation of Provision

The bill extends the due date for the cargo diversion study until July 1, 1988.

C. Omnibus Budget Reconciliation Act of 1986 (Sec. 203 of the Bill)

1. Exclusion of discharge of indebtedness income in determining tax-exempt status of mutual or cooperative telephone and electric companies (sec. 203(a) of the bill, sec. 1011(a) of the Omnibus Budget Reconciliation Act of 1986, sec. 623 of Public Law 99-591, and sec. 501(c)(12)(A) of the Code)

Present Law

Under present law, benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations are exempt Federal income tax (other than on unrelated business taxable income) so long as 85 percent or more of the income of the organization consists of amounts collected from members for the sole purpose of meeting losses and expenses (Code sec. 501(c)(12)). In the case of mutual or cooperative telephone companies, the 85-percent test is determined without regard to income received or accrued from (1) nonmember telephone companies for the performance of communication services with members, (2) certain pole rentals, and (3) the sale of display listing in a directory furnished to members. In the case of mutual or cooperative electric companies, the 85-percent test is determined without regard to income received or accrued from certain pole rentals.

Also under present law, gross income includes "income from discharge of indebtedness" (sec. 61(a)(12)). A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. The amount of the indebtedness discharged is equal to the difference between the face amount of the debt, adjusted for any unamortized premium or discount, and any consideration given by the taxpayer to effect the discharge.

Section 1011(a) of the Omnibus Budget Reconciliation Act of 1986 and section 623 of Public Law 99-591 provided that certain loans made pursuant to sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 could be prepaid at an amount less than the principal amount of the debt.

Explanation of Provision

The bill provides that, in the case of mutual or cooperative telephone companies or electric companies, the 85-percent test of section 501(c)(12) is to be determined without regard to any income from discharge of indebtedness arising from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936, as in effect of January 1, 1987.

2. Payment period for excise taxes on imported beverages and tobacco products (sec. 203(b) of the bill, sec. 8011 of the Omnibus Budget Reconciliation Act of 1986, and secs. 5061 and 5073 of the Code)

Present Law

The excise taxes on alcoholic beverages and tobacco products are imposed on removal of a taxable product from bonded premises. Tax on domestically produced articles (and distilled spirits imported in bulk) is paid with respect to semi-monthly periods, with tax being due 14 days after the close of each semi-monthly period. Tax on imported products (other than distilled spirits imported in bulk) is due 14 days after the date on which the taxable product enters the customs territory of the United States.

Explanation of Provision

The bill conforms the payment periods for excise taxes imposed on imported alcoholic beverages and tobacco products generally to those presently applicable to domestic products. Thus, tax on these imported products will be paid with respect to semi-monthly periods, with tax being due 14 days after the close of each semi-monthly period.

3. Gross-up of dividends by payor's foreign tax payments (sec. 203(c) of the bill, sec. 8041 of the Omnibus Budget Reconciliation Act of 1986, and sec. 901(j) of the Code)

Present Law

Generally, a taxpayer can claim a foreign tax credit for foreign income taxes paid or deemed paid, or the taxpayer can claim a deduction for foreign income taxes paid. A taxpayer generally cannot, however, claim a credit with respect to some foreign income taxes and a deduction with respect to others (sec. 275(a)(4)(A)). If a domestic corporation subject to this "either-or" rule chooses to credit foreign income taxes, then taxes paid by a foreign subsidiary and deemed paid by the domestic corporation add to ("gross up") any dividend or income inclusion received by the latter.

Pursuant to Code provisions added by the Omnibus Budget Reconciliation Act of 1986 and amended by the Revenue Act of 1987, income taxes paid to certain governments are ineligible for the foreign tax credit (sec. 901(j)). Such taxes are deductible. Moreover, contrary to the generally applicable "either-or" rule described above, such taxes are deductible even if the taxpayer chooses the benefit of the foreign tax credit provisions with respect to income taxes paid to countries not affected by these provisions (sec. 901(j)(3)). In the case of dividends or inclusions received by a domestic corporation from a foreign corporation whose foreign tax payments are deemed paid by the domestic corporation, Congress intended that the income of the latter be the amount of the dividend or inclusion net of (i.e., not grossed up by) foreign taxes paid by the foreign corporation that are not creditable under section 901(j).

Explanation of Provision

The amendment clarifies that the income of any domestic corporation receiving dividends or inclusions from a foreign corporation is not grossed up by foreign taxes the latter pays that are not creditable under section 901(j), regardless of whether the domestic corporation otherwise chooses the benefits of the foreign tax credit.

D. Revenue Act of 1987 (Sec. 204 of the Bill)

1. Accounting provisions (sec. 204(c)-(d) of the bill)

a. Installment sales (sec. 204(c) of the bill, sec. 10202 of the Revenue Act, and secs. 453 and 453A of the Code)

Present Law

The Revenue Act of 1987 repealed the installment method for all dealer dispositions of property occurring after December 31, 1987. A dealer disposition is defined as (1) any disposition of personal property by a person who regularly sells or otherwise disposes of personal property on the installment plan, and (2) any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business. The definition of dealer disposition does not include (1) dispositions of property used or produced in the trade or business of farming, and (2) dispositions of residential lots or "timeshares" with respect to which interest is paid.

The 1987 Act also provided special installment sale rules that apply to the sale of non-farm real property that is used in a taxpayer's trade or business or that is held for the production of rental income where the selling price of such real property is greater than $150,000. First, an interest charge is imposed on the tax that is deferred under the installment method to the extent attributable to the amount by which the deferred payments arising from all dispositions of such real property during any year exceeds $5 million. Second, if any indebtedness is secured directly by an installment obligation that arises out of the disposition of such property, the net proceeds of the secured indebtedness is treated as a payment on such installment obligation.

Explanation of Provision

The bill contains four technical corrections to the installment sale provisions of the 1987 Act. First, the definition of dealer disposition for purposes of the installment method repeal is clarified to exclude personal property that is not regularly sold or otherwise disposed of on the installment plan.

Second, the bill provides the Treasury Secretary with additional regulatory authority. Under the bill, the Treasury Secretary is provided regulatory authority to disallow the use of the installment method in whole or in part for transactions in which the rules relating to nondealer real property installment obligations would be avoided through the use of related persons, pass-through entities, or intermediaries. The bill also provides the Treasury Secretary with regulatory authority to treat the sale of an interest in a partnership or other pass-through entity as a sale of the underlying assets of the partnership or other entity.

Third, the bill clarifies the treatment of nondealer real property installment obligations that arise out of dispositions occurring after August 16, 1986, but in a taxable year prior to the first taxable year ending after December 31, 1986, for taxpayers that elect early application of the interest charge. The deferred tax from these obligations is subject to an interest charge to the extent attributable to the amount by which the deferred payments from these obligations exceeds the amount that bears the same ratio to $5 million as the number of days after August 16, 1986, and before the first day of the first taxable year ending after December 31, 1986, bears to 365.

Fourth, the bill provides additional rules relating to the adjustment resulting from the change in method of accounting that is required by the repeal of the installment method for dealer dispositions. This adjustment is required to be included in income at a rate no slower than the rate of contraction of the taxpayer's dealer installment obligations. In addition, any loss from the disposition of a dealer installment obligation is not recognized currently, but, instead, reduces the amount of the adjustment includible in income for the last taxable year in the adjustment period. If the loss exceeds the adjustment for such last taxable year, then the loss is to reduce the adjustment for the preceding taxable year in the adjustment period.

b. Election of a taxable year other than a required taxable year (sec. 204(d) of the bill, sec. 10206 of the Revenue Act, and secs. 444, 7519, and 280H of the Code)

Present Law

Partnerships, S corporations, and personal service corporations generally are required to conform their taxable years to that of their owners, effective for taxable years beginning after December 31, 1986.

The Revenue Act of 1987 provided an election for a partnership, S corporation, or personal service corporation that would otherwise be required to conform its taxable year to that of its owners to retain the taxable year it used for its last taxable year beginning in 1986. Alternatively, an election may be made to change to a taxable year with a deferral period not in excess of three months, so long as the taxable year changed to does not have a deferral period greater than the deferral period of the taxable year used by the entity at the time of the change. An election also may be made by a new partnership, S corporation or personal service corporation to adopt a taxable year with a deferral period not in excess of three months. The deferral period of a taxable year is the number of months between the beginning of the taxable year elected and the close of the required taxable year that ends within the taxable year elected.

The election may not be made by an entity that is part of a tiered structure, other than a tiered structure that is comprised of one or more partnerships or S corporations, all of which have the same taxable year. Once an election has been terminated, no further election may be made.

An electing partnership or S corporation must make a "required payment" for any taxable year for which an election is in effect. An electing personal service corporation must meet minimum distribution requirements during the portion of its fiscal year that ends December 31. If such minimum distribution requirements are not met, the electing personal service corporation is limited in the amount of payments to employee-owners that it may deduct for that taxable year.

Explanation of Provision

Tiered structures

The bill clarifies the application of the rule prohibiting an election of a taxable year other than a required taxable year (sec. 444 election) by an entity that is part of a tiered structure, other than a tiered structure comprised of one or more partnerships or S corporations all of which have the same taxable year. The bill provides that this rule applies during the entire period an entity desires to have a section 444 election in effect. The bill also provides that any section 444 election is terminated if the entity becomes part of a tiered structure. The exception to the prohibition for tiered structures comprised of one or more partnerships or S corporations, all of which have the same taxable year, applies whether all such entities are partnerships, S corporations, or both partnerships and S corporations, so long as all such entities have the same taxable year. No other tiered structures satisfy the exception to the prohibition.

Definitions

The bill provides a definition of "personal service corporation" and clarifies the definition of "employee-owner." The bill provides that these terms have the same meaning given them in section 269A, as modified by section 441(i)(2).

The bill also provides that the term "applicable payment" means amounts paid by a partnership or S corporation that are includible in the gross income of a partner or shareholder. An applicable payment is not considered to occur prior to the date that it is includible in the gross income of the partner or shareholder receiving the payment. The term "applicable payment" does not include any gain from the sale or exchange of property between a partner or shareholder and a partnership or S corporation or any dividend paid by an S corporation.

The bill provides that the term "deferral period" means the months between the beginning of a taxable year and the close of the first taxable year ending within such year, except as provided in regulations. In the case of a taxable year that is also a required taxable year, the deferral period is zero. It is anticipated that the regulations will include rules for determining the "deferral period" for the first taxable year of new entities and in the case of changes in taxable years by established entities.

Required payments by electing partnerships and S corporations

The bill clarifies the computation of the required payment that must be made by an electing partnership or S corporation. The amount of the required payment for an election year is the excess of (1) the applicable percentage of the adjusted highest section 1 rate multiplied by the net base year income of the entity, over (2) the net required payment balance. The net required payment balance is the aggregate amount of required payments and refunds for all preceding election years. Thus, the amount of required payments for all preceding election years, net of any refunds of such payments, is taken into account in determining the amount of payment required for the current election year.

For example, an electing partnership has made required payments of $10,000 and $20,000 for its first and second applicable election years, and has claimed a refund of required payments in the amount of $5,000 for its third applicable election year. Thus, the net required payment balance for the fourth applicable election year of the partnership is $25,000. In the fourth applicable election year, the applicable percentage of the adjusted highest section 1 rate is 29 percent and the net base year income of the partnership is $100,000. The required payment for the fourth applicable election year of the partnership will be $4,000.[1]

Refunds of required payments

The bill clarifies the circumstances under which an electing partnership or S corporation is entitled to a refund of all or a portion of its net required payment balance.

In general, an electing partnership or S corporation is eligible for a refund of that portion of the net required payment balance that exceeds the amount of the required payment for the current year before reduction by the net required payment balance. An electing partnership or S corporation is also eligible for a refund of the entire amount of the net required payment balance if the election is terminated, or if the partnership or S corporation is liquidated during an election year. In the case of a termination of an election or liquidation of the entity, the refund is payable on the later of April 15 of the calendar year following the calendar year in which the termination or liquidation occurs, or 90 days after the claim for such refund is filed with the Secretary of the Treasury.

The bill also clarifies that an election is terminated when an S corporation revokes its S corporation status or a corporation that was a personal service corporation no longer is a personal service corporation.

Required payments of S corporations

The bill clarifies the computation of net base year income in the case of an electing S corporation that was a C corporation during the base year. The bill provides that the corporation is treated as having been an S corporation during the base year for the purpose of determining the amount and timing of applicable payments.

Guaranteed payments

The bill clarifies the treatment of guaranteed payments by a partnership in determining the amount of an electing partnerships required payment. Under the bill, the net income of an electing partnership is determined without reduction for any guaranteed payments. A guaranteed payment is not treated as an applicable payment for the purpose of computing the required payment of the partnership.

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[1] (.29 X $100,000) - $25,000 = $4,000.

Applicable percentage

The bill provides that the applicable percentage for any partnership or S corporation is 100 percent for any taxable year beginning after 1987, if more than 50 percent of the entity's net income for the short taxable year that otherwise would have resulted had the election not been made is allocable to partners or shareholders that would not have been eligible to include such short taxable year income over a four-year period.

For example, a corporation elects S status for its taxable year beginning July 1, 1987. If the S corporation does not make a section 444 election, it will be required to change to a December 31 taxable year. If the S corporation changes to a December 31 taxable year, the shareholders are not entitled to a four-year spread on their prorata share of the S corporation's taxable income for the period July 1 to December 31, 1987. If the S corporation makes a section 444 election, the applicable percentage for its taxable year beginning in 1987 is 25 percent, while the applicable percentage for taxable years beginning after 1987 is 100 percent.

Net income of partnerships and S corporations

The bill clarifies the treatment of tax-exempt income earned by an electing partnership or S corporation by providing that tax-exempt income is not included in determining the net income of an electing partnership or S corporation.

Elections by corporations electing S status after September 18, 1986, and before January 1, 1988

The bill provides that the provision allowing corporations that elected S status after September 18, 1986, and before January 1, 1988, to use the deferral period of the last taxable year the corporation was a C corporation in determining what fiscal year end may be elected applies only if the section 444 election is made for a taxable year beginning before 1989.

Minimum distribution requirements of personal service corporations

The bill clarifies the rules used in determining if a personal service corporation has met its minimum distribution requirements. The minimum distribution requirements are met if the applicable amounts paid during the deferral period equal or exceed the lesser of (1) the applicable amounts paid during the preceeding taxable year divided by the number of months in such preceeding taxable year multiplied by the number of months in the deferral period of the preceeding taxable year or (2) the applicable percentage of the adjusted taxable income for the deferral period of the current taxable year.

For this purpose, the adjusted taxable income for the deferral period is determined without regard to a deduction for any amount paid to an employee-owner that is includible in the gross income of such employee-owner and without regard to any net operating loss carryover to the extent that such net operating loss carryover is attributable to amounts paid to employee-owners.

2. Partnership provisions (sec. 204(e)-(g) of the bill)

a. Certain publicly traded partnerships treated as corporations (sec. 204(e) of the bill, sec. 10211 of the Revenue Act, and sec. 7704 of the Code)

Present Law

Under present law, a publicly traded partnership is treated as a corporation for Federal tax purposes unless 90 percent or more of its gross income consists of qualifying income. A partnership is publicly traded if (1) interests in the partnership are traded on an established securities market, or (2) interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Qualifying income under the provision means interest, dividends, real property rents, gain from the disposition of real property, and income and gains from certain natural resources activities. Qualifying income also includes gain from disposition of a capital asset or section 1231(b) property that is held for the production of qualifying income. It also includes income and gains from certain commodities and commodities futures, options and forward contracts of partnerships, a principal activity of which is buying and selling such commodities or commodities futures, options or forward contracts.

Present law provides relief from classification as a corporation for Federal tax purposes, in the case of inadvertent failure to meet the requirement that 90 percent or more of the partnership's gross income consist of qualifying income. The partnership may be treated as continuing to meet the 90 percent test with respect to gross income if (1) the Treasury Secretary determines that failure to meet the 90 percent requirement was inadvertent, (2) the partnership takes steps within a reasonable time to meet the 90 percent requirement, and (3) the partnership agrees to make such adjustments (including adjustments with respect to the partners) as are required by the Treasury Secretary with respect to the period of inadvertent failure to meet the 90 percent requirement.

The provision is effective with respect to taxable years beginning after December 31, 1987. A 10-year grandfather rule is provided in the case of existing partnerships; the provision is effective for existing partnerships for taxable years beginning after December 31, 1997. The grandfather rule ceases to apply in the case of partnerships that otherwise would be treated as existing partnerships, with respect to which there has been an addition of a substantial new line of business. For this purpose, the transfer of assets to the partnership and commencement of business, substantially as described or provided for in the registration statement and filed exhibits thereto (including subsequent amendments and filings related thereto that do not add descriptions of new lines of business), and the sale of interests in the partnership will not be treated as the addition of a substantial new line of business. It is not intended that the termination (within the meaning of section 708) of such a partnership as a result of the issuance or sale of partnership interests cause the partnership not to be treated as an existing partnership.

Explanation of Provisions

The bill clarifies the Treasury regulatory authority to implement relief from classification as a corporation in the event of inadvertent failure to meet the requirement that 90 percent or more of a publicly traded partnership's gross income consist of qualifying income. Regulatory authority is provided under the bill to cause the partnership to make adjustments or to pay amounts required by the Treasury Secretary. The amounts of such payments are intended to represent an appropriate portion of tax liability that would be imposed on the partnership if it were treated as a corporation during the period of failure to meet the 90 percent requirement. In implementing this rule, the Treasury Department may also limit the relief where a publicly traded partnership inadvertently fails to meet the 90 percent test in each of several successive years, or in several years within a longer period[2], thus causing the partnership to be treated as a corporation in such circumstances. This grant of regulatory authority carries out the intention of the provision to provide relief for temporary, inadvertent failures, without permitting partnerships to conduct substantial activities not contemplated under the rules describing qualifying income.

It is also expected that under the regulatory authority provided with respect to inadvertent failures of the 90 percent requirement, the Treasury Department will provide rules for determining the application of the 90 percent test in the case of short taxable years of a partnership.

The bill also provides a rule coordinating the 90 percent requirement with the 10-year grandfather rule for existing partnerships. The bill provides that an existing (i.e., grandfathered) publicly traded partnership is not treated as a corporation under the provision until the earlier of (1) its first taxable year beginning after December 31, 1997, or (2) its first taxable year beginning after the day (if any) that the partnership ceases to be treated as an existing partnership by reason of the addition of a substantial new line of business with respect to such partnership. An existing partnership becomes subject to the provisions of section 7704 (e.g., the 90 percent requirement) upon the earlier of these to occur. If an existing publicly traded partnership ceases to be treated as an existing partnership, but satisfies the 90 percent requirement (and the other requirements of sec. 7704), then such a partnership is not thereupon reclassified as a corporation for tax purposes under the provision.

Thus, for example, a publicly traded partnership that is an existing partnership within the meaning of the provision for the entire period between December 31, 1987 and December 31, 1997, and meets the 90 percent requirement for the first time for its entire taxable year beginning January 1, 1998, is not treated as a corporation under the provision either for the period 1988-1997, or for its taxable year 1998.

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[2] Cf. sec. 1362(d), imposing a 3-consecutive-year limit on excess net passive income of certain S corporations.

It is intended that a publicly traded partnership not be treated as ceasing to be an existing partnership solely by reason of a termination of the partnership (within the meaning of sec. 708) caused by the sale or exchange through trading of 50 percent or more of the partnership interests.

b. Treatment of publicly traded partnerships under the passive loss rules (sec. 204(f) of the bill, sec. 10212 of the Revenue Act, and sec. 469(k) of the Code)

Present Law

Present law provides that net income and loss from each publicly traded partnership (that is not treated as a corporation for Federal tax purposes) is subject to separate application of the passive loss rules. Each partner in a publicly traded partnership treats his share of net income or loss from the partnership (other than portfolio income or loss from the partnership) as separate from the net income or loss from any other passive activity. Thus, a partner's share of non-portfolio income from the partnership cannot be offset by losses from other publicly traded partnerships or other passive activities; and a partner's share of losses from the partnership (other than losses described in sec. 469(e)(1)) is suspended.

The legislative history to the 1987 Act provides that upon a complete disposition of the partner's entire interest in a publicly traded partnership, any remaining suspended losses are allowed.[3]

Explanation of Provision

The bill codifies the legislative history that a partner in a publicly traded partnership is treated as having made a disposition which results in suspended losses being allowed in accordance with section 469(g) only when he disposes of his entire interest in the partnership (rather than upon disposition of an activity of the partnership as under the passive loss rule applied outside the publicly traded partnership context).

c. Treatment of certain partnership allocations (sec. 204(g) of the bill, sec. 10214 of the Revenue Act, and sec. 514(c)(9) of the Code)

Present Law

Unrelated business taxable income exception

Under present law, income from debt-financed property generally is treated as unrelated business income to tax-exempt organizations. An exception from the unrelated business income tax is provided in the case of debt-financed real property of a qualified pension plan, educational organization or title holding company (i.e., a qualified tax-exempt organization (section 514(c)(9)(C)).

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[3] See H.R. Rpt. No. 100-495, Conference Report to Accompany H.R. 3545, Omnibus Budget Reconciliation Act of 1987 (100th Cong., 1st Sess.) at 951.

Disproportionate allocation rule

Income from debt-financed real property of a partnership that includes both tax-exempt and taxable organizations can qualify under the unrelated business income exception if each allocation to a tax-exempt organization that is a partner is a qualified allocation (within the meaning of sec. 168(h)(6)), or if the partnership meets the requirements of the "disproportionate allocation rule" (sec. 514(c)(9)(E)). A partnership satisfies the disproportionate allocation rule if throughout the entire period that a tax-exempt organization is a partner (1) no distributive share of overall partnership loss allocable to a taxable partner can exceed such partner's smallest distributive share of overall partnership income for any taxable year, and (2) no distributive share of overall partnership income allocable to a tax-exempt partner can exceed such partner's smallest distributive share of overall partnership loss for any taxable year ((1) and (2) being sometimes referred to as the "fractions rule"). In addition, the disproportionate allocation rule requires that throughout the entire period that a tax-exempt organization is a partner, each partnership allocation must have substantial economic effect (within the meaning of sec. 704(b)).

The provision permits (except as otherwise provided in regulations) chargebacks of income or loss to particular partners to offset the amount of prior disproportionate allocations of loss or income that were consistent with the general rule. The amount of a chargeback cannot exceed the amount of the prior allocation, and must be made in the same ratio as the prior allocation. Thus, chargebacks may be slower, but not faster, than they might otherwise be absent the restriction.

The provision also grants Treasury regulatory authority to provide for reasonable preferred returns (i.e., priority cash distributions) or reasonable guaranteed payments (within the meaning of sec. 707(c)).

Substantial economic effect requirement

Present law requires that a partner's distributive share of partnership items have substantial economic effect, or the items will be re-allocated in accordance with the partner's interest in the partnership (sec. 704(b)). Under the section 704(b) regulations, allocations generally have economic effect if (1) the partners' capital accounts are properly maintained, (2) partnership liquidating distributions must be made in accordance with the partners' capital accounts, and (3) the partners must restore any deficit capital account upon liquidation of the partnership (Treas. Reg. sec. 1.704-1(b)(2)((ii)). In general, the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners, independent of tax consequences (Treas. Reg. sec. 1.704-1(b)(2)(iii)).

The regulations also contain an alternate test for economic effect. Under that test, certain allocations to a partner are deemed to have economic effect, even though the partner is not obligated to restore any deficit balance in his capital account, if requirements (1) and (2) above (relating to capital accounts and liquidating distributions) are satisfied, and the partnership agreement contains a "qualified income offset." Under a qualified income offset, if a partner unexpectedly receives certain capital account adjustments, allocations of loss or deduction, or distributions that cause a deficit in the partner's capital account, then that partner must be allocated income and gain to eliminate the deficit as quickly as possible (Treas. Reg. sec. 1.704-1(b)(2)(d)).

Under the regulations, allocations of certain types of losses or deductions are described as not having economic effect. These include allocations of loss or deduction with respect to nonrecourse debt, and other items such as credits and percentage depletion in excess of basis. The regulations provide a safe harbor for determining whether the allocation of certain such items (such as nonrecourse deductions) is valid (Treas. Reg. sec. 1.704-1(b)(4)).

Explanation of Provision

The bill provides Treasury regulatory authority to prescribe such regulations as are necessary to carry out the purposes of the provision, including regulations that may provide for the exclusion or segregation of items.

In providing this regulatory authority, it is recognized that the fractions rule and the requirement that allocations have substantial economic effect may appear inconsistent in certain circumstances. Given a particular economic arrangement, existing regulations with respect to substantial economic effect may in some cases impose requirements that are at odds with those imposed under the fractions rule.

The Treasury Department is directed to resolve conflicts under this provision in a manner that carries out the purpose of the provision to limit the transfer of tax benefits from tax-exempt partners to taxable partners. The transfer of tax benefits limited under the provision could otherwise occur either through deferral of income to the taxable partner by directing income to the tax-exempt partner, or through directing losses and deductions to the taxable partner. In general, it is expected that under the regulatory authority provided in the bill, the Treasury Department will give the fractions rule precedence over the substantial economic effect requirement in identified situations involving a conflict between them. It is expected that there is no circumstance in which it would be appropriate to waive the application of both the fractions rule and the substantial economic effect requirement with respect to an allocation of a partnership item.

In particular, the existing regulations governing substantial economic effect state that allocations of items funded by nonrecourse debt cannot have economic effect (and therefore cannot have substantial economic effect). The existing regulations, however, provide a safe harbor for allocating items attributable to nonrecourse debt.

Under the regulatory authority provided in the bill, it is expected that the Treasury regulations will require allocations of items attributable to nonrecourse debt to meet the fractions rule, whether or not such allocations satisfy existing regulations or are deemed to have substantial economic effect.

The Treasury Department may, in exercising this regulatory authority, partially or fully waive the fractions rule in the case of allocations of loss attributable to tort liability of the partnership that the tax-exempt partners did not expect to share in as part of their investment in the partnership. Such tort liability includes personal injury liability arising from the partnership's maintenance of a building open to the public (e.g., if someone falls and injures himself in the lobby of a building owned by the partnership). Allocations of such losses or deductions are expected to be required to meet the substantial economic effect test.

3. Corporate tax provisions (sec. 204(h)-(l) of the bill)

a. Reduction in dividends received deduction for dividends from corporations not 20-percent owned (sec. 204(h) of the bill, sec. 10221 of the Revenue Act, and sec. 243 of the Code)

Present Law

The Act reduced to 70 percent the dividends received deduction available to corporate shareholders owning less than 20 percent of the stock of the distributing corporation. Twenty-percent or more corporate shareholders remain eligible for an 80-percent dividends received deduction. The reduction is effective for dividends received or accrued after 1987. A clerical error in the effective date of the Act suggests that the availability of the 80-percent dividends received deduction to some 20-percent or more corporate shareholders was temporarily suspended by the Act.

Explanation of Provision

The bill corrects the clerical error in the effective date.

b. Computation of earnings and profits for purposes of intercorporate dividends and basis adjustments under consolidated return provisions (overruling of *Woods Investment Co.*) (sec. 204(i) of the bill, sec. 10222 of the Revenue Act, and secs. 1503(e) and 301(f) of the Code)

Present Law

Under the Act, solely for purposes of determining gain or loss on disposition, a parent corporation's basis in the stock of a subsidiary with which it files or has filed a consolidated return ("intragroup stock") is determined by computing earnings and profits of the subsidiary without regard to sections 312(k) and (n). Thus, for example, the parent's basis for purposes of determining gain or loss is adjusted based on the tax depreciation claimed by the subsidiary during the period the subsidiary was a member of the parent's affiliated group, rather than an adjustment based on the depreciation claimed by the subsidiary for earnings and profits purposes.

The conference agreement states that the provision is intended to apply in the case of any transaction or event that is treated as a disposition of the stock of a subsidiary under the consolidated return regulations and that the amount of any excess loss account with respect to a subsidiary will be determined after making the adjustments prescribed by the Act.

The conference report states that the Treasury Department shall promulgate regulations addressing cases where a prior owner was not subject to this provision.

The Act also expands the scope of prior law rules regarding the computation of earnings and profits for purposes of determining the effects of corporate distributions to a corporation that owned 20 percent or more of the stock of the distributing corporation at the time of the distribution. Among other things, these rules affect the basis of the stock of the distributing corporation in the hands of the distributee, for purposes of determining gain or loss on disposition of such stock.

The Act generally applies to dispositions or distributions after December 15, 1987, except that transition relief is provided for certain dispositions of intragroup stock after that date pursuant to certain arrangements in effect on or before that date. Intragroup stock is defined as stock in a corporation which is or was a member of an affiliated group of corporations and is held by another member of such group.

Explanation of Provision

Coordination with excess loss account rules

The bill clarifies the application of the basis adjustment provision of the Act where basis in the stock of a subsidiary has been reduced to zero, and any further negative adjustments would result in an excess loss account under the consolidated return regulations[4]. The purpose of this provision of the Act was generally to modify the consolidated return rules relating to basis adjustments, which are based on earnings and profits of a subsidiary, so that gain, loss, or other income recognition on disposition of the stock are the same as if sections 312(k) and (n) had never been enacted. Consistent with this purpose, the bill provides that for purposes of computing the amount of an excess loss account, which determines income on the disposition of stock, earnings and profits are computed in accordance with the provisions of the Act. Thus, for example, an excess loss account generally will be increased by the amount of depreciation on subsidiary assets claimed for tax purposes.

The timing and character of the income recognition with respect to an excess loss account is governed by the normal consolidated return rules. Accordingly, any event that triggers all or a portion of an excess loss account under the consolidated return regulations[5] is a disposition for purposes of section 1503(e), and the amount of the inclusion will be determined after the recomputations of earnings and profits required under that section. For example, if an affiliated group of corporations filing a consolidated return disposes of sufficient stock of a subsidiary to break consolidation, this will generally cause recognition of the entire excess loss account, including the portion of the account attributable to stock retained by the group. As would be the case if the provisions of sections 312(k) and (n) had never been enacted, the basis in the retained stock following such a disposition shall be zero under section 1503(e).

Similarly, it is not intended that any gain or income recognized by reason of the Act's adjustments would duplicatively increase the disposing corporation's earnings and profits for purposes of determining the amount of any distribution that is a dividend, to the extent that earnings and profits for this purpose had already reflected such increase by virtue of sections 312(k) or (n).

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[4] See Treas. Reg. sec. 1.1502-19.

[5] See Treas. Reg. sec. 1.1502-19(b)

The bill provides that if an excess loss account disposition event was not subject to the Act, any remaining stock, when disposed of, will be treated as having a negative basis equal to the portion allocable to such stock of the unrecaptured amount that would have been the excess loss account if a prior disposition had been subject to the Act.

Adjustments for property acquired by a corporation prior to becoming a member of the affiliated group.

The bill states that, under regulations prescribed by the Secretary, proper adjustments shall be made in the application of the basic statutory rule in the case of property acquired by a corporation before it became a member of the affiliated group filing a consolidated return, for the difference between the adjusted basis of such property for purposes of computing taxable income and its adjusted basis for purposes of computing earnings and profits. Such cases include but are not limited to cases where the corporation that holds the pre-affiliation property was not formerly a member of another affiliated group filing a consolidated return or was the common parent of such a group.

In such cases, regulations must take into account the application of section 312(k) to property placed in service prior to such affiliation. Thus, for example, in such cases it is expected that regulations will provide that, instead of the adjustments prescribed by section 1503(e)(1), the stock basis that would otherwise result from the application of the section 312(k) earnings and profits basis will generally be adjusted only to the extent of the excess, if any, of tax depreciation over earnings and profits depreciation during the period the property is owned by the affiliated group filing the consolidated return. Similar appropriate modifications to the adjustments provided by section 1503(e)(1) shall apply in the case of the other items (besides depreciation).

Basis adjustment under section 48(q)

The bill provides that, under regulations, proper adjustments in the application of the basic statutory rule will also be made for any basis adjustments under section 48(q). That section provides that the basis of property shall be reduced when various business credits have been taken. Generally, the reduction is 50 percent of any investment credit[6] and 100 percent of the rehabilitation tax credit taken with respect to such property.

It is intended that the regulations under the bill will provide that, for purposes of determining gain or loss on disposition of stock, the basis of the stock of a member of an affiliated group claiming such a credit shall also be reduced by the amount of the reduction in the basis of the assets of that corporation under section 48(q).

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[6] The Tax Reform Act of 1986 repealed the regular investment credit except in the case of certain transition property whose basis is adjusted by 100 percent of the investment tax credit.

Certain redemptions

The bill clarifies that the Act did not change prior law in the case of redemptions described in section 312(n)(7) of the Code. Thus, if a corporation distributes amounts in a redemption described in that section, the basis of the stock of that corporation will be adjusted to reflect the part of the distribution which is properly chargeable to earnings and profits under section 312(n)(7).

Effective date of amendment to section 301(f)

The bill clarifies that in the case of the amendment to section 301(f) of the Code, dealing with distributions received by 20-percent corporate shareholders, the transition rule applies to dispositions even though the stock may not be and may never have been "intragroup" stock with respect to the selling corporation because the corporations were never in an affiliated group filing a consolidated return.

c. Mirror subsidiary transactions (sec. 204(j) of the bill, sec. 10223 of the Revenue Act, and secs. 304 and 355 of the Code)

Present Law

The Act provides that, in the case of a transfer of stock of one member of an affiliated group to another member of such group in a transaction described in section 304(a) of the Code, proper adjustments must be made in the bases of intragroup stock and in the earnings and profits of each member of the group to the extent necessary to carry out the purposes of that provision. The Act further provides that these adjustments shall not apply to transfers after December 15, 1987, when the transfer is between corporations which are members of the same affiliated group on December 15, 1987, or which became members of the same group before January 1, 1989, pursuant to a binding written contract or tender offer in effect on December 15, 1987; provided in each transition case that the transfer occurs before January 1, 1993.

The Act provides that section 355 does not apply to any distribution by a corporation if control of the distributing corporation was acquired by a corporate distributee within five years prior to the distribution.

The Act also provides that the provisions therein concerning mirror subsidiary transactions would, in general, be effective for distributions after December 15, 1987. An exception is provided in cases where 80 percent of the stock (by vote and by value) of the distributing corporation was acquired by the distributee prior to that date or was acquired after that date pursuant to a binding written contract or tender offer in effect on that date, and the acquisition is completed before January 1, 1989; provided in each transition case the distribution occurs before January 1, 1993.

Explanation of Provision

The bill clarifies that the provision in the Act relating to the treatment of intragroup transactions under section 304 only applies to transfers from one member of an affiliated group to another member of the group.

The bill provides that transition relief for intragroup transactions under section 304 applies only if the intragroup transfer occurs before March 31, 1988 (the date of introduction of the bill) and is between corporations which were members of the same affiliated group on December 15, 1987 or became members of such group pursuant to a binding written contract or tender offer in effect on December 15, 1987.

No inference is intended by the transition rule in the Act and the bill concerning transactions described in section 304(a) of the Code as to the proper tax treatment of transactions under prior law. In addition, no inference is intended that the Act imposes any limitation on the Treasury Department's authority to establish or clarify the tax consequences of transactions under prior law, including transactions which are covered by the transition rule.

The bill clarifies that, as under prior law, section 355 does not, in general, apply to any distribution by a corporation if, within five years prior to the distribution, the distributing corporation acquires control, directly or indirectly, of a corporation which (at the time of the acquisition of control) was conducting the active trade or business of the distributing corporation or the controlled corporation.

The bill clarifies that, for purposes of the exception from the effective date provision concerning mirror subsidiary transactions in cases where 80 percent of the stock of the distributing corporation is acquired by the distributee, all distributees which are members of the same affiliated group will be treated as one distributee.

d. Limitation on use of preacquisition losses to offset built-in gains (sec. 204(l) of the bill, sec. 10226 of the Revenue Act, and sec. 384 of the Code)

Present Law

The 1987 Act limited a corporation's ability to offset gains that accrued prior to a merger or acquisition against preacquisition losses of a second corporation. Under one rule (the "stock acquisition rule"), if a gain corporation (one with a net unrealized built-in gain in excess of a de minimis threshold amount) becomes a member of an affiliated group, income of the corporation attributable to recognized built-in gains cannot be offset by preacquisition losses of other members of the group. Under a second rule (the "asset acquisition rule"), if the assets of a gain corporation are acquired by another corporation in a tax-free subsidiary liquidation under section 332 or in a tax-free reorganization, the income of the acquiring corporation attributable to recognized built-in gains of the gain corporation may not be offset by preacquisition losses of the acquiring corporation, or of members of its affiliated group.

An exception to both the stock acquisition rule and the asset acquisition rule is provided for preacquisition losses of a corporation (or affiliated group of corporations) that has held more than 50 percent of the gain corporation's stock for five years or longer.

A recognized built-in gain is defined as any gain recognized during the five-year period beginning on the acquisition date, except to the extent the taxpayer establishes that the gain accrued after the acquisition date. Items of income attributable to periods before the acquisition date are also treated as recognized built-in gain.

A preacquisition loss is defined as any net operating loss carryforward to the taxable year in which the acquisition date occurs (or any built-in loss recognized during the recognition period), and the portion of any loss incurred in the taxable year of the acquisition allocable to the period before the acquisition date.

Explanation of Provision

Events triggering limitation

The bill provides that the stock acquisition rule applies if one corporation acquires (directly or indirectly) control of another corporation and either corporation is a gain corporation. Control is defined as stock representing 80 percent of the vote and value of a corporation within the meaning of section 1504(a)(2). The asset acquisition rule applies if either the acquired or the surviving corporation is a gain corporation.

Application to successor corporations

The bill clarifies that the limitation applies to any successor corporation to the same extent it applied to its predecessor.

For example, assume that corporation L, which has net operating loss carryovers, acquires control of corporation G, which has net unrealized built-in gain in excess of the de minimis threshold. The two corporations subsequently file a consolidated return. Under the stock acquisition rule, income attributable to G's recognized built-in gains may not be offset by L's preacquisition losses during the subsequent five-year recognition period. If G is liquidated into L under section 332 within five years after the acquisition, income attributable to G's recognized built-in gains may not be offset by L's preacquisition losses during the remainder of the five-year period.[7] The same result would occur if L merged downstream into G.

As another example, assume the same facts as above but that, three years after G was acquired by L, G merges into unrelated corporation X (also a gain corporation). Assume that X (the survivor and successor to G) thereafter files a consolidated return with L. Under the successor rule, during the two remaining years of the recognition period with respect to G, L is precluded from using its preacquisition losses—those attributable to periods before it acquired control of G—against income of X attributable to built-in gains inherited from G that would have been subject to such limitation prior to the merger. In addition, the general asset acquisition rule would prevent X's built-in gains that accrued prior to the merger with G but that are recognized during the 5-year recognition period following that merger from being offset by losses of L accruing before that merger.

As under the Act, the limitations of section 384 apply independently of and in addition to the limitations of section 382.

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[7] The successor rule renders unnecessary the application of the asset acquisition rule to section 332 liquidations, and the bill accordingly deletes such liquidations from the rule.

Treatment of affiliated corporations (including definition of preacquisition loss)

The bill clarifies that (except to the extent provided in regulations and subject to the successor rule described above) all corporations which are members of the same affiliated group immediately before the acquisition date shall be treated as one corporation.

Thus, for example, the determination of whether the de minimis threshold for built-in gain or loss is satisfied is to be made on an affiliated group basis, unless regulations provide otherwise.

In addition, if a corporation becomes a member of an affiliated group and subsequently merges with another member, although any gains or losses which were limited under section 384 as a result of the stock acquisition rule when the corporation became a member of the group will continue to be limited, gains or losses accruing after the date of affiliation and before the merger will not be preacquisition gains or losses with respect to the merger.

To the extent provided in regulations, an affiliated group for this purpose includes corporations that would be members but for the exclusions in section 1504(b) (foreign corporations, certain insurance companies, etc.).

Common control exception

The bill modifies the exception from the limitation for more than 50-percent ownership over a five-year period in two respects.

First, the exception applies in any case where the gain corporation and the corporation with the preacquisition loss were members of the same "controlled group" at all times during the five-year period. For this purpose, controlled group has the same meaning as under section 1563(a) (relating to limitations on multiple tax benefits in the case of certain related corporations), except that 50-percent rather than 80-percent ownership is required, and both voting *and* value must be held. Thus, for example, if a foreign corporation is the common parent of such a group, the exception applies.

Second, the bill provides that if the gain corporation was not in existence throughout this five-year period, the exception is applied by substituting the period of its existence. It is intended that this rule will be interpreted together with the successor rule to prevent the avoidance of the purpose of the rule through the use of a newly formed company to acquire or otherwise combine its assets with assets of a corporation that would be subject to the limitations.

Conforming amendment to rules relating to net operating loss carryovers and carrybacks

The bill provides that, if a taxpayer is prevented from using a preacquisition loss against a recognized built-in gain under this provision, the gain is not taken into account in applying the rules relating to carryovers and carrybacks of net operating losses, excess credits, and capital losses. Thus, the loss (or credit) carryover is not reduced when it cannot be used by reason of this provision.

e. Greenmail payments (sec. 204(m) of the bill, sec. 10228 of the Revenue Act, and sec. 5881 of the Code)

Present Law

The Act provides that a person who receives "greenmail" is subject to a non-deductible 50-percent excise tax on any gain realized on such receipt.

Explanation of Provision

The bill clarifies that the tax on greenmail will be imposed on any gain or other income of a person by reason of the receipt of greenmail. For example, if a person realizes dividend income by reason of receiving a greenmail payment, the tax will be imposed on the amount of the dividend received.

The bill clarifies that, subject to certain conditions, "greenmail" includes any consideration transferred by a corporation, or any person acting in concert with such corporation, to directly or indirectly acquire stock of such corporation from any shareholder.

The bill clarifies that the deficiency procedures relating to Tax Court jurisdiction apply to the greenmail excise tax.

4. Estate tax: Estate freezes (sec. 204(o) of the bill, sec. 10402 of the Revenue Act, and sec. 2036(c) of the Code)

Present Law

Under certain circumstances, if a person in effect transfers property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining a disproportionately large share of the income of, or rights in, the enterprise, then the retention of the retained interest is treated as a retention of the enjoyment of the transferred property (sec. 2036(c)). The value of the transferred property is includible in the transferor's gross estate if he retains the retained interest for his life, for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death. In addition, the value of the transferred property as of the date of death is includible if the retained interest is disposed of within three years of the transferor's death.[8]

The value is includible regardless of whether the transferee retains his interest in the enterprise. In addition, property may be brought into the estate even if the transferor makes subsequent transfers which restore proportionality.

For example, assume that a person who holds all the preferred and common stock in a corporation gives away half the common stock and retains all other stock until his death. The value of the common stock given away is included in that person's estate even if the transferee subsequently transfers his stock to a person who is not a member of the transferor's family. Also, if the transferor subsequently gives the transferee half the preferred stock and retains half the common and preferred stock, stock held by the transferee may nonetheless be included in the transferor's estate.

Explanation of Provision

In general

If either the original transferor transfers his retained interest, or the original transferee transfers the transferred property to a person who is not a member of the original transferor's family, then the original transferor is treated as making a gift of property equal to the amount which would have been includible under section 2036(c) in his estate had he died at that time (determined without regard to secs. 2032 and 2032A). No amount would later be included in the transferor's estate under section 2036(c) to the extent that such gift is deemed to have been made.

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[8] It may includible even if the retained interest is sold for its fair market value within three years of the transferor's death. See *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961).

For example, assume that a person who holds all the preferred and common stock in a corporation gives away the common stock while retaining the preferred stock. If the transferor or transferee subsequently transfers all of his stock to a person outside the transferor's family, the original transferor is treated as having made a gift with respect to the common stock at that point in time. The common stock will not thereafter be included in the transferor's estate under section 2036(c).

Transfers of a portion of an interest

Where either the transferee or transferor transfers a portion of the retained or transferred interest, a proportionate amount is treated as a transfer by gift. The remaining portion of the retained interest would still be includible in the transferor's estate. Thus, in the previous example, if the transferor or the transferee subsequently transfers half of his stock to a person not a member of the transferor's family, the transferor is treated as having made a gift with respect to half of the common stock at that point in time and that half would not be includible in his estate. The other half of the common stock would still be includible in the transferor's estate.

A subsequent transfer gives rise to a gift under this provision only to the extent that the transfer restores proportionality with respect to all classes of interests whose retention gave rise to the application of section 2036(c). For example, a person who holds all the stock in a corporation and gives away the common stock while retaining all of two classes of preferred stock would be treated as making a gift under the provision only to the extent that he subsequently transfers a proportionate amount of each class of preferred stock. If he subsequently transfers 25 percent of one class and 75 percent of the other class of preferred stock, he would under the provision be treated as making a gift with respect to only the 25 percent of the common stock with respect to which proportionality was restored. His estate would still include 75 percent of the common stock—the share for which disproportionate ownership continues to exist after the subsequent transfer.

Transfers within three years of death

Gifts made under this provision are considered in computing the transferor's Federal estate tax (sec. 2001(b)). In addition, the transferor's gross estate is increased by the amount of Federal gift tax attributable to gifts made under the provision within three years of death (sec. 2035(c)). Such gifts would be valued as of the date of the gift rather than the date of death.

Transfers by transferee to a member of transferor's family

No gift is deemed under the provision when the transferee transfers his interest to a member of the original transferor's family. Rather, the transferred interest remains includible in the original transferor's estate. For instance, where a grandparent transfers common stock to a child and retains preferred stock, there is no gift under the provision when the child subsequently transfers the common stock to the transferor's grandchild. If the grandchild later transfers the common stock to a person who is not a member of the grandparent's family, there is a gift under the provision at that time; otherwise, the common stock is included in the grandparent's estate.

Treasury Regulations

The bill requires that the Secretary of the Treasury prescribe such regulations as are appropriate to carry out the purposes of section 2036(c) or to prevent avoidance of its purposes through distributions or otherwise. It is intended that such regulations may treat certain distributions to the transferee as giving rise to a gift by the transferor. For a distribution which approaches a liquidation, the amount of the gift could be the entire amount which would have been included in the transferor's estate had the transferor died immediately before the transfer. For other distributions treated as giving rise to a gift under the regulations, the amount of the gift might be limited to the amount of the distribution. Such a gift tax could be assessed on distributions, which, while not liquidating in nature, nonetheless present avoidance possibilities, such as where an enterprise distributes ten percent of its income and assets for ten successive years, leaving it an empty shell.

5. Definition of active participant for IRA deduction (sec. 204(b) of the bill)

Present Law

Under present law, a taxpayer is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income, in the case of a self-employed individual) if—

(1) in the case of a taxpayer who is not married, the taxpayer either (a) has adjusted gross income (AGI) that does not exceed the applicable dollar amount or (b) is not an active participant for any part of the plan year ending with or within the taxable year;

(2) in the case of married taxpayers filing a joint return, either (a) the couple has AGI that does not exceed the applicable dollar amount or (b) neither spouse is an active participant for any part of the plan year ending with or within the taxable year; or

(3) in the case of a married taxpayer filing separately, the taxpayer either (a) has AGI that does not exceed the applicable dollar amount or (b) neither spouse is an active participant for any part of the plan year ending with or within the taxable year.

For purposes of these rules, an active participant is an individual who is an active participant in (1) a qualified pension, profit-sharing, or stock bonus plan; (2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension (sec. 408(k)); (4) a plan established for its employees by the United States, by a State or political subdivision thereof, or by any agency or instrumentality of the United States or of a State or political subdivision thereof (other than an unfunded deferred compensation plan subject to sec. 457); (5) a plan described in section 501(c)(18); or (6) a tax-sheltered annuity (sec. 403(b)).

The applicable dollar amount is (1) $25,000, in the case of an unmarried individual, (2) $40,000, in the case of a married couple filing a joint return, and (3) $0, in the case of a married taxpayer filing separately. The otherwise applicable IRA dollar limit (i.e., $2,000) is reduced by an amount that bears the same ratio to such dollar limit as the taxpayer's AGI in excess of the applicable dollar amount (or, in the case of a married couple filing a joint return, the couple's AGI in excess of the applicable dollar amount) bears to $10,000.

In a Tax Court decision (*Porter v. Commissioner*, 88 T.C. No. 28 (March 5, 1987)), it was held that Article III judges are not employees of the United States and, therefore, are not active participants in a plan established for its employees by the United States.

Under the Act, the Tax Court decision in *Porter v. Commissioner* was overturned, and Federal judges are treated as employees for income tax purposes and as active participants for purposes of the

IRA deduction limit, effective for years beginning after December 31, 1987.

The United States Court of Appeals for the Third Circuit, recently affirmed the Tax Court result, although on different grounds (*Adams v. Commissioner*, Nos. 87-1394 through 87-1397, March 7, 1988). The Third Circuit held that Article III judges are not covered by a plan established by the United States and therefore are not active participants in such a plan.

Explanation of Provision

The Act provided that Federal judges are to be treated as active participants, thereby subjecting such judges (and their spouses) to the phaseout of the IRA deduction. The Third Circuit decision does not affect the impact of this provision of the Act. However, to clarify further this impact, the bill provides that Federal judges are to be considered active participants in a plan established for its employees by the United States. Therefore, for example, if a married Federal judge filing a joint return has AGI of $50,000 in a taxable year, neither the judge nor the judge's spouse may deduct any contributions to an IRA for such year.

E. Pension Protection Act (Sec. 205 of the Bill)

1. Minimum Funding Standard and Deductions

a. Modifications of minimum funding standard (sec. 205(b) of the bill, sec. 9303 of the Pension Protection Act, sec. 412 of the Code, and sec. 302 of ERISA)

(1) Deficit reduction contribution

Present Law

Under the Act, additional minimum funding requirements apply to defined benefit plans (other than multiemployer plans) if the assets of the plan are less than 100 percent of current liability. For such plans, the amount otherwise required to be charged to the funding standard account is increased by the sum of (1) the excess of (a) the deficit reduction contribution over (b) certain charges and credits to the funding standard account, plus (2) the unpredictable contingent event amount. The deficit reduction contribution is equal to the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount.

Unfunded old liability generally includes unfunded liabilities as of the beginning of the first plan year beginning after December 31, 1987 (determined without regard to plan amendments after October 16, 1987). The unfunded old liability amount is increased by the amount necessary to amortize over 18 plan years the unfunded existing benefit increase liability, which in general is certain increases in liabilities due to benefit increases under collective bargaining agreements ratified before October 17, 1987. Unfunded existing benefit increase liability is unfunded current liability determined by (1) taking into account only liabilities attributable to the benefit increase, and (2) by reducing plan assets by the plan's current liability determined without regard to the benefit increase.

Unfunded new liability is the unfunded current liability determined without regard to the unamortized portion of the unfunded old liability and the liability with respect to any unpredictable contingent event benefits (without regard to whether or not the event has occurred).

The Act's new funding rule for unpredictable contingent event benefits is effective with respect to plan years beginning after December 31, 1988. However, the new rule does not apply to benefits with respect to which the event on which the benefit is contingent occurred before October 17, 1987. Such benefits are funded under the pre-Act rules; that is, generally as an experience loss.

Explanation of Provision

Under the bill, as under the Act, unfunded existing benefit increase liability is unfunded current liability determined by (1) taking into account only liabilities attributable to the benefit increase, and (2) by reducing plan assets by the plan's current liability determined without regard to the benefit increase. The bill clarifies that the calculation in (2) does not reduce plan assets below zero.

Under the bill, unfunded new liability is the unfunded current liability determined without regard to (1) the unamortized portion of the unfunded old liability, (2) the unamortized portion of the unfunded existing benefit increase liability, and (3) the liability with respect to any unpredictable contingent event benefits (without regard to whether or not the event has occurred). The bill thus conforms the treatment of unamortized existing benefit increase liability to the treatment of unamortized old liability for purposes of determining unfunded new liability.

The bill provides that the new funding rule for unpredictable contingent event benefits applies to such benefits with respect to which the event on which the benefit is contingent occurs in a plan year beginning after December 31, 1988. Benefits with respect to which the contingency occurs before a plan year beginning before January 1, 1989, are subject to the otherwise applicable funding rules, generally as an experience loss. This change in the effective date is made to eliminate issues arising with respect to transition from the pre-Act funding rule to the Act's funding rule for benefits with respect to which the contingency occurs after October 16, 1987, and before a plan year beginning after December 31, 1988.

(2) Current liability

Present Law

The Act provides that, in determining current liability, certain preparticipation service is to be disregarded. Unfunded current liability is the excess of the plan's current liability over plan assets. For this purpose, plan assets are reduced by any credit balance in the funding standard account.

Explanation of Provision

The bill provides that assets are to be reduced by any credit balance in the funding standard account for purposes of the new funding requirements (sec. 412(l)), and that, in other places where the term "unfunded current liability" is used, the Secretary may provide for such a reduction. Unfunded current liability is relevant not only for purposes of the new minimum funding requirements, but also for a number of other purposes under the Act. In calculating unfunded current liability, it is appropriate to reduce assets by any credit balance in the funding standard account for some purposes (such as the new funding rules) but not for others.

It is anticipated that no reduction will be made for purposes of the rule permitting deductions up to the amount of unfunded current liability (Code sec. 404(a)(1)(D)), the lien on missed contributions (Code sec. 412(n)), the security requirement for certain benefit increases (Code sec. 401(a)(29)), or the additional Pension Benefit Guaranty Corporation (PBGC) premium (ERISA sec. 4006(a)(3)(E)).

In accordance with the legislative history, the bill provides that the rule disregarding certain preparticipation service does not apply with respect to a participant who does not, at the time of becoming a participant, have years of service in excess of the years required for plan eligibility.

The bill also provides that the rule disregarding preparticipation service is elective. The rule was intended to provide relief for employers in certain situations, for example, if the employer establishes a new plan that takes into account past service. The rule does not need to be imposed where the employer does not need such relief. The bill provides that the election not to take advantage of the rule may be revoked only with the consent of the Secretary. Of course, if an employer does disregard preparticipation service, such service is disregarded for all purposes in calculating current liability. Thus, for example, it would be disregarded for purposes of the deduction rules as well as the minimum funding rules.

(3) Valuations

Present Law

Present law provides that a determination of experience gains and losses and a valuation of the plan's liability is to be made not less frequently than once every 3 years, except that such determination is to be made more frequently to the extent required in particular cases under regulations prescribed by the Secretary.

Explanation of Provision

The bill provides that plan valuations are to be made not less frequently than annually. Annual valuations are necessary under the Act's minimum funding rules because the minimum required contribution for a plan year depends on the plan's funded status for that year.

(4) Steel employee plans

Present Law

The Act provides a special funding transition rule with respect to steel employee plans. The contribution required under this special rule is, in general, the sum of (1) the required percentage of the current liability of the plan, plus (2) a portion of the unpredictable contingent event benefit liability. The required percentage depends in part on the plan's funded current liability percentage. In calculating the funded current liability percentage for this purpose, the unpredictable contingent event benefit liability and contributions relating to such liability are disregarded.

Explanation of Provision

For purposes of calculating the funded current liability percentage under the steel employee plan rule, the bill provides that unpredictable contingent event benefit liability, contributions relating to such liability, and income on such contributions are disregarded. The exclusion of income on such contributions is consistent with the Act's intent to provide a separate funding rule for unpredictable contingent event benefit liability.

(5) Rule for self-employed individuals

Present Law

A nondeductible excise tax is imposed on nondeductible contributions to a qualified employer plan equal to 10 percent of the nondeductible contributions, determined as of the close of the taxable year of the employer (sec. 4972). Contributions to a plan on behalf of a self-employed individual (as defined in sec. 401(c)(4)) are not deductible to the extent the contributions exceed the earned income of the individual. Contributions on behalf of a self-employed individual in excess of earned income may be required to be made under the minimum funding rules. Thus, the excise tax may apply to contributions that are required by law to be made to the plan.

Explanation of Provision

The bill provides that contributions required to meet the minimum funding rules are not subject to the 10-percent excise tax on nondeductible contributions, even if the contributions exceed the earned income of the self-employed individual. The bill does not change the deduction rule with respect to contributions on behalf of such individuals.

b. Time for contributions (sec. 205(c) of the bill, sec. 9304 of the Pension Protection Act, sec. 412(c), (m) of the Code, and sec. 302(c), (e) of ERISA)

Present Law

The Act requires that installment payments of estimated contributions be made throughout the plan year. This requirement applies to plans subject to the minimum funding standards other than multiemployer plans.

A special installment payment rule applies with respect to unpredictable contingent event benefits. Under this rule, the otherwise required installment is increased by the greater of (1) the amount of unpredictable contingent event benefits paid during the 3-month period preceding the month in which the installment is due, and (2) 25 percent of the amount which would be determined for the plan year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 plan years.

If a required installment is not paid in full by the due date for the installment, then the funding standard account is charged with interest on the underpayment at the rate that is the greater of (1) 175 percent of the applicable Federal mid-term rate, or (2) the plan rate in effect under section 412(b)(5).

The Act provides that the employer is required to notify plan participants and beneficiaries and the PBGC if the employer fails to make required contributions with respect to a plan.

The Act provides that a lien arises if required contributions are not paid and the unpaid balance of required contributions exceeds $1 million. The lien provision is effective with respect to plan years beginning after December 31, 1987. Contributions originally due before the effective date, including contributions that would have been due before the effective date but were waived, are not subject to the lien, but are taken into account in determining whether the $1 million threshold is met.

Explanation of Provision

The Act provides that the installment payment requirement applies only to defined benefit plans (other than multiemployer plans) that are subject to the minimum funding requirements. Thus, under the bill, the installment payment requirement does not apply to money purchase pension plans. This is consistent with the general purpose of the pension provisions of the Act, which is to address problems associated with single employer defined benefit pension plans.

The bill modifies the special installment payment rule with respect to unpredictable contingent event benefits to conform the rule to the funding rule for such benefits. Under the bill, the otherwise required installment (determined without regard to unpredictable contingent event benefits) is increased by the greater of (1) the unfunded percentage (as determined under sec. 412(l)(5)(A)) of unpredictable contingent event benefits paid during the 3-month period preceding the month in which the installment is due, or (2) 25 percent of the amount required to be contributed for the plan year under the amortization rule for such benefits (sec. 412(l)(5)(A)(ii)).

The bill clarifies that the interest rate on underpayments of required installments is the greater of (1) 175 percent of the applicable Federal mid-term rate, or (2) the rate of interest used under the plan to determine costs (including any adjustments required for plans subject to the new funding rules under section 412(l)). Thus, under the bill, the interest rate on underpayments will be at least equal to the interest rate the plan is using under the minimum funding rules.

The bill adds a sanction for failure to notify plan participants and beneficiaries of the failure to make required contributions. Under the bill, a court may require an employer who fails to comply to pay the affected participants and beneficiaries up to $100 per day from the date of the failure. This sanction is consistent with the existing sanctions under ERISA for failure to provide participants and beneficiaries with required information.

The bill conforms the Act to the legislative history by providing that the notice requirement with respect to participants and beneficiaries is effective with respect to plan years beginning after December 31, 1987.

The bill adds a penalty for failure to notify the PBGC of the failure to make required contributions. Under the bill, the PBGC may assess a penalty, payable to the PBGC, of up to $1,000 for each day for which the failure to provide the required notice continues. This penalty is consistent with the penalty added by the Act with respect to the failure to provide certain other information to the PBGC. Under the bill, as under the Act, the amount of the penalty is to reflect the materiality of the failure to provide the required information.

c. Funding waivers (sec. 205(d) of the bill, sec. 9306 of the Pension Protection Act, sec. 412(d) of the Code, and sec. 303 of ERISA)

Present Law

Under the Act, the interest rate on waived contributions in the case of a plan other than a multiemployer plan is the greater of (1) 150 percent of the applicable Federal mid-term rate, or (2) the rate of interest used under the plan in determining costs.

Prior to the Act, a funding waiver could not be granted with respect to a plan for more than 5 of any 15 consecutive plan years. Under the Act, a waiver cannot be granted with respect to a plan for more than 3 of any 15 consecutive plan years. This provision of the Act applies to any waiver application submitted after December 17, 1987, and any waiver granted pursuant to such an application. In applying the Act's new limit on the number of waivers, the number of waivers which may be granted pursuant to applications submitted after December 17, 1987, is to be determined without regard to waivers granted with respect to plan years beginning before January 1, 1988.

Explanation of Provision

The bill provides that, for purposes of determining the interest rate on waived contributions, adjustments required for plans subject to the new funding rules under section 412(1) are taken into account in calculating the plan's interest rate. Thus, under the bill, the interest rate on waived contributions will be at least equal to the interest rate the plan is using under the minimum funding rules.

Under the bill, the reduction in the number of waivers that can be granted within a 15-year period is effective with respect to waivers for plan years beginning after December 31, 1987. In determining whether the new frequency requirement is satisfied, waivers granted with respect to plan years beginning before January 1, 1988, are not taken into account. Waivers for plan years beginning before January 1, 1988, are subject to the pre-Act frequency limit. Under the effective date provisions of the Act with respect to frequency of waivers, it would be possible to obtain a waiver that did not count for purposes of the pre-Act frequency limit or the Act's frequency limit. These changes address this situation.

d. Limitation on deduction for contributions to certain plans not less than unfunded current liability (sec. 205(e) of the bill, sec. 9307(c) of the Pension Protection Act, and sec. 404(a)(D) of the Code)

Present Law

Under the Act, in the case of a defined benefit plan (other than a multiemployer plan) which has more than 100 participants for the plan year, the maximum amount deductible is not less than the unfunded current liability of the plan (sec. 404(a)(1)(D)). For purposes of this rule, all defined benefit plans maintained by the same employer (or any member of the employer's controlled group) are treated as one plan. The Act provides that, in calculating the unfunded current liability for purposes of this deduction rule, assets are not reduced by the credit balance in the funding standard account.

Under present law, an overall deduction limit applies if an employer maintains a defined contribution plan and a defined benefit plan covering the same employees. A provision of the bill also applies the limit to certain other combinations of plans. Under this rule, the maximum allowable deduction is the greater of (1) 25 percent of the compensation of the beneficiaries under the plans, or (2) the amount of contributions made to the defined benefit plan to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard for the plan year which ends with or within the taxable year (or for any prior plan year) (sec. 404(a)(7)). This overall limit is in addition to the otherwise applicable individual plan limits.

Carryover amounts (i.e., amounts paid in a prior taxable year that were not previously deductible) may be deducted pursuant to the section 404(a)(1)(D) rule. For this purpose, present law provides that plan assets are to be treated as reduced by the plan's carryover amount.

Explanation of Provision

The bill clarifies that the aggregation of all defined benefit plans only applies for purposes of determining whether a plan has more than 100 participants. Thus, the aggregation rule does not require that all defined benefit plans of the employer be aggregated for purposes of determining whether the plan has unfunded current liability.

The bill deletes the language that specifies that assets are not reduced by the credit balance in the funding standard account for purposes of calculating unfunded current liability under the deduction rule. This language is no longer necessary because, under the bill, unfunded current liability is calculated without such a reduction, except for purposes of the new minimum funding rules or as provided by the Secretary (see above). It is intended that the Secretary will not provide for such a reduction for purposes of this deduction rule.

For purposes of the overall deduction limit, the bill provides that, in the case of a defined benefit plan (other than a multiemployer plan) with more than 100 participants, the amount necessary to satisfy the minimum funding standard is not less than the unfunded current liability of the plan. This change conforms the overall deduction limit to the rule permitting deductions up to unfunded current liability.

e. Limitation on interest rate (sec. 205(e) of the bill, sec. 9307(e) of the Pension Protection Act, sec. 412(b) of the Code, and sec. 302(b) of ERISA)

Present Law

Under the Act, the interest rate used for certain purposes under the minimum funding rules is required to be (1) within a specific permissible range, and (2) within that range, consistent with the interest rate which would be used by an insurance company to establish the amount it would charge an employer to satisfy the liabilities under the employer's plan. The permissible range under the Code is, in general, not more than 10 percent above and not more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during a 4-year period.

Explanation of Provision

To reflect the legislative history, the bill provides that these special interest rate rules apply for purposes of determining current liability and for purposes of determining a plan's required contribution under the funding rules applicable to plans with assets less than current liability. Thus, the bill clarifies that these special rules do not apply for all purposes under the minimum funding rules. For purposes for which these special rules do not apply, the plan's interest rate is required to be reasonable in light of the experience of the plan and reasonable expectations.

The bill conforms the definition of the permissible range in ERISA to the Code definition of the permissible range.

f. Effective date of changes relating to amortization periods (sec. 205(e) of the bill, and sec. 9307(f) of the Pension Protection Act)

Present Law

In the case of plans other than multiemployer plans, the Act reduced the period for amortizing experience gains and losses from 15 years under prior law to 5 years. This change is effective for years beginning after December 31, 1987.

Explanation of Provision

To conform to the legislative history, the bill provides that the change in the amortization period for experience gains and losses applies to gains and losses established in years beginning after December 31, 1987. The bill also provides a special transition rule for certain 1987 gains and losses. Under this rule, any experience gain or loss determined by a valuation occurring as of January 1, 1988, is treated as established in a year beginning before January 1, 1988.

2. Employer Access to Plan Assets; Limitations on Employer Reversions upon Plan Termination (sec. 205(g) of the bill, sec. 9311 of the Pension Protection Act, and sec. 4044(d) of ERISA)

Present Law

The Act provides that a plan amendment or provision providing for or increasing a reversion to the employer is not effective before the end of the fifth calendar year following the date the provision or amendment is adopted. The Act also provides a transition rule for certain plans that allows plan amendments within one year of the effective date to take effect without regard to the 5-year rule.

The Act also made other changes relating to the distribution of assets on termination that are effective, in general, with respect to distress terminations with regard to which notices of intent to terminate are provided after December 17, 1987, and plan terminations instituted by the PBGC after December 17, 1987.

Explanation of Provision

The bill clarifies the effective date of the 5-year rule. First, the bill clarifies that the rule applies, in general, to plan provisions or amendments adopted after December 17, 1987.

Second, the bill clarifies the transition rule. Under the bill, a plan that does not contain any provision regarding the distribution of residual assets can be amended, within one year from December 17, 1987, to provide for an employer reversion without regard to the 5-year rule. If, however, after December 17, 1987, a plan provides for distribution of residual assets to employees, then the transition rule does not apply.

With respect to the other changes relating to distribution of assets, the bill clarifies that the changes also apply to standard terminations with respect to which the notice of intent to terminate is issued after December 17, 1987.

3. Treatment of Plan Terminations

a. Elimination of ERISA section 4049 trust (sec. 205(h) of the bill, sec. 9312 of the Pension Protection Act, and sec. 4022 of ERISA)

Present Law

Prior to the Act, the employer's liability payments for unfunded benefits in excess of guaranteed benefits were paid to a special trust established under section 4049 of ERISA. The Act eliminates the section 4049 trust, and provides that the employer's entire liability following plan termination is to be paid to the PBGC. The PBGC then is to pay both guaranteed and nonguaranteed benefits to participants and beneficiaries. The amount of nonguaranteed benefits paid to participants and beneficiaries depends on the applicable recovery ratio.

In the case of terminations where the unfunded benefit liabilities exceed a certain amount, the applicable recovery ratio is based on the actual recovery from the employer (the "large plan" rule). In the case of other terminations, the applicable recovery ratio is based on the average recovery from prior terminations with respect to which the notice of intent to terminate is provided after December 17, 1987 (the "small plan" rule). In order to enable the PBGC to establish the recovery ratio for plans subject to the small plan rule, in the case of terminations with respect to which notices of intent to terminate are provided on or before December 17, 1990, payments to participants and beneficiaries are based on recovery from the particular termination. The Act provides that the transition rule does not apply if the recovery ratio is not finally determined as of December 17, 1990.

The provisions relating to the elimination of the section 4049 trust apply to distress terminations with respect to which notices of intent to terminate are provided after December 17, 1987, and terminations instituted by the PBGC after such date.

Explanation of Provision

The bill provides that, in determining the recovery ratio under the small plan rule, the terminations taken into account are those with respect to which the notice of intent to terminate was provided after December 17, 1987, and within the 5 fiscal years of the Federal Government ending before the year in which the date the notice of intent to terminate the plan for which the recovery ratio is being determined was provided.

The bill provides that the transition rule for small plans applies to all terminations with respect to which the notice to terminate is provided after December 17, 1987, and on or before December 17, 1990. Thus, the transition rule is not limited to situations where the recovery ratio is finally determined as of December 17, 1990. This limit on the transition rule unduly limited the application of the transition rule.

The bill clarifies that the provisions apply to all terminations where notice of intent to terminate is provided after December 17, 1987. The bill also makes additional conforming changes needed to reflect the elimination of the section 4049 trust.

b. Standards for termination (sec. 205(i) of the bill, sec. 9313 of the Pension Protection Act, and sec. 4041(c) of ERISA)

Present Law

In order to terminate a plan in a distress termination, the plan sponsor and each member of the sponsor's controlled group must demonstrate that it meets one of several distress criteria as of the date of plan termination. In a distress termination, the plan administrator is required to provide certain information relating to plan assets and benefits to the PBGC.

Explanation of Provision

The bill provides that the distress criteria must be satisfied as of the proposed date of plan termination, and clarifies that the information relating to plan assets and benefits is to be provided as of the proposed termination date and, if applicable, the proposed distribution date.

4. Miscellaneous

a. Security rules for underfunded plans (sec. 205(j) of the bill, sec. 9341 of the Pension Protection Act, sec. 401(a)(29) of the Code, and sec. 307 of ERISA)

Present Law

In the case of a defined benefit plan (other than a multiemployer plan), if a plan amendment is adopted and the funded current liability percentage of the plan (taking into account the amendment) is less than 60 percent, then the contributing sponsor (or any member of the contributing sponsor's controlled group) is required to provide security to the plan. The amount of the security is the excess of (1) the lesser of (a) the amount of plan assets necessary to increase the funded current liability percentage under the plan to 60 percent, or (b) the amount of the increase in current liability under the plan attributable to the plan amendment, over (2) $10 million.

The security provisions are contained both in the Code (as a qualification requirement) and in ERISA. The Code provision provides that the Secretary of the Treasury may issue regulations with respect to partial releases of the security by reason of increases in the funded current liability percentage.

The provisions generally apply to plan amendments after December 22, 1987. Under a special rule, in the case of a plan maintained pursuant to one or more collective bargaining agreements ratified before December 22, 1987, the provisions do not apply to plan amendments adopted pursuant to such collective bargaining agreements.

Explanation of Provision

The bill clarifies that, in determining the amount of security that must be provided, the increase in current liability attributable to the plan amendment and all plan amendments after December 22, 1987, are taken into account. Thus, for example, an employer cannot avoid the security requirement by adopting a series of plan amendments, each one of which separately results in an increase in current liability that is below the $10 million threshold but which together increase current liability by more than the $10 million threshold.

The bill provides that the security provision does not apply to plans that are not subject to the minimum funding requirements. Thus, for example, the provision does not apply to church or governmental plans.

The bill conforms the ERISA provision to the Code provision by clarifying that the Secretary of the Treasury has regulatory authority with respect to partial release of the security.

The bill provides that a contributing sponsor that is required to provide security is required to notify the PBGC of the plan amendment. This change conforms the statutory provisions to the legislative history. The PBGC may assess a penalty, payable to the PBGC, of up to $1,000 for each day the required notice is not provided. This penalty is consistent with the penalty added by the Act for the failure to provide certain other information to the PBGC. Under the bill, as under the Act, the penalty is to reflect the materiality of the failure to provide the required information.

With respect to the special effective date for collectively bargained plans, the bill provides that extensions, amendments, or modifications of the bargaining agreement on or after December 22, 1987, are disregarded.

b. Reporting requirements (sec. 205(k) of the bill, sec. 9342 of the Pension Protection Act, and sec. 103(d) of ERISA)

Present Law

Under the Act, the annual report for the plan must contain additional information regarding the funded status of the plan if the value of plan assets is less than 60 percent of current liability.

The Act authorizes the Secretary of Labor to assess a civil penalty of up to $1,000 for each day the plan administrator fails to file an annual report.

Explanation of Provision

The bill reflects the legislative history by providing that this requirement applies with respect to a plan if the value of plan assets is less than 70 percent of current liability. The bill also clarifies that, in the case of plans with assets less than 70 percent of current liability, the annual report is to include the percentage which the value of plan assets is of current liability.

The bill authorizes the Secretary of Labor to bring a civil action to collect the penalty for failure to file an annual report. The bill also clarifies that the plan administrator is liable for the penalty.

c. Coordination of provisions of the Internal Revenue Code of 1986 with provisions of ERISA (sec. 205(m) of the bill, sec. 9343 of the Pension Protection Act, and sec. 403 of ERISA)

Present Law

Under ERISA, plan assets cannot be returned to the employer prior to termination of the plan, except in certain limited circumstances. Prior to the Act, section 403(c)(3) of ERISA provided for the return of contributions which would otherwise be excess contributions as defined in section 4972(b) of the Code, to the extent that section 4972 provides for return of the contributions. In a conforming change, the Act replaced the references to section 4972 of the Code with a reference to section 4979 of the Code, which relates to contributions that do not satisfy the special nondiscrimination rules applicable to qualified cash or deferred arrangements and similar arrangements.

Explanation of Provision

The bill deletes section 403(c)(3) of ERISA. It is no longer necessary in light of recent changes in the Code.

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), section 4972 of the Code provided an excise tax on excess contributions to certain plans maintained by self-employed individuals, and for the return of such contributions in order to avoid the excise tax. As part of TEFRA's changes making the rules applicable to plans maintained by self-employed persons more like the rules applicable to other qualified plans, section 4972 (in its then present form) was repealed.

Neither present-law section 4972 of the Code nor present-law section 4979 of the Code provides for return of contributions to the employer. Thus, neither section should be a basis for the exception to the general rule prohibiting return of assets to the employer prior to plan termination.

d. Plan investment in employer securities (sec. 205(l) of the bill, sec. 9345 of the Pension Protection Act, and sec. 407 of ERISA)

Present Law

The Act amended the definition of qualifying employer security. This change was intended to apply only to plans that are not individual account plans.

Explanation of Provision

The bill clarifies that the new definition of qualifying employer security applies only to plans that are not individual account plans.

F. Excise Tax on Certain Vaccines (sec. 206 of the bill, sec. 9201 of the Revenue Act, and secs. 4132 and 9510 of the Code)

Present Law

An excise tax is imposed on the sale by a manufacturer or importer of DPT, DT, MMR, and polio vaccines. The occurance and timing of a sale is determined by applying general excise tax principles (*see*, e.g. Treas. reg. 48.0-2(b)). General excise tax principles treat use of an article subject to tax in a taxable manner as a taxable event if that use occurs before sale of the article.

An amount equivalent to revenues produced by this tax are deposited in the Vaccine Injury Compensation Trust Fund. Individuals to whom these vaccines are administered are eligible for compensation from the Trust Fund for certain injuries that occur within specified periods following their vaccination. Individuals to whom vaccines are administered in U.S. possessions are eligible for compensation in the same manner as individuals receiving vaccines in the United States.

Explanation of Provision

The general excise tax rule treating certain uses as taxable events is codified with respect to the vaccine tax.

Clarification is provided as to the point where taxation occurs in the case of taxable vaccines taken from the United States to a U.S. possession.

G. Other Provisions

1. Disregard of certain housing assistance payments in determining income and resources under SSI program (sec. 207 of the bill)

Present Law

Assistance provided under the United States Housing Act of 1937 is excluded (by sec. 2 of the Housing Authorization Act of 1976) from consideration as income or resources for SSI purposes. The Housing and Community Development Act of 1987 (Public Law 100–242) transferred the authorization of housing assistance for the nonelderly disabled from section 8 of the United States Housing Act of 1937 to section 202 of the Housing Act of 1959, effective for projects developed and contracts made with funds appropriated after enactment. Public Law 100–242 did not, however, specifically exclude the consideration of this assistance as income or resources under the newly-amended Housing Act of 1959.

Explanation of Provision

The bill amends section 1612(b) of the Social Security Act to exclude the value of Federal housing assistance from income and resources for SSI purposes.

2. Social Security Act technical corrections (sec. 208 of the bill)

a. Reference to Social Security Act

Present law

Section 205(c)(2)(C)(iii) of the Social Security Act authorizes States to use social security numbers for purposes of administering general assistance, issuing drivers' licenses, and registering motor vehicles in certain circumstances.

Explanation of Provision

The bill replaces a reference to "the Social Security Act" with "this Act".

b. Net earnings from self-employment

Present Law

Section 211(a)(7) of the Social Security Act (as amended by section 9023(b)(1) of Public Law 100–203) defines net earnings from self-employment for ministers and members of religious orders.

Explanation of Provision

The bill adds a reference, inadvertently omitted, to the Internal Revenue Code of 1986.

c. Medicare coverage for disabled children and widows and widowers

Present Law

Section 226(b) of the Social Security Act (as amended by section 9010(e)(3) of Public Law 100-203) provides a minimum of 39 months of continuing Medicare eligibility to disabled social security recipients whose earings during a trial work period exceed Substantial Gainful Activity (SGA).

Explanation of Provision

The bill conforms the period of Medicare coverage in cases involving disabled children and disabled widow(ers) to that for disabled workers.

d. Definition of employee for social security tax purposes

Present Law

Section 3121(d) of the Internal Revenue Code (as amended by section 9002(b)(2) of Public Law 99-509) and section 3306(i) of the Internal Revenue Code (as amended by section 9002(b)(2) of Public Law 99-509) defined employee for social security tax purposes.

Explanation of Provision

The bill redesignates paragraph (3) as (4) and vice versa and makes conforming changes.

e. Individuals employed on small fishing boats

Present Law

Section 3121(b)(20) of the Internal Revenue Code (as amended by Section 13303(c)(2) of Public Law 99-272) establishes the Social Security tax treatment of individuals employed on small fishing boats.

Explanation of Provision

The bill replaces "312(b)" of Public Law 99-272 (a typographical error) with "3121(b)", and makes a conforming change in section 210(a) of the Social Security Act.

f. Employee cash tips

Present Law

Section 9006 of Public Law 100-203 requires employers to pay social security tax on the full amount of their employees' cash tips, up to the social security wage base.

Explanation of Provision

The bill strikes an incorrect reference in section 9006 to Code section “3111(a) and substitutes Code section “3111”.